INSIDE THIS WEEK: A 14-PAGE SPECIAL REPORT ON SPAIN

The Economist

NOVEMBER 8TH–14TH 2008 www.economist.com

Great expectations



Home
This week's print edition
Daily news analysis
Opinion
All opinion
Leaders
Letters to the Editor
Blogs
Columns
KAL's cartoons
Correspondent's diary
Economist debates
World politics
All world politics
Politics this week
International
United States
The Americas
Asia
Middle East and Africa
Europe
Britain
Special reports
Business
All business
Business this week
Management
Business education
Finance and economics
All finance and economics
Economics focus
Economics A-Z
Markets and data
All markets and data
Daily chart
Weekly indicators
World markets
Currencies
Rankings
Big Mac index
Science and technology
All science and technology
Technology Quarterly
Technology Monitor
Books and arts
All books and arts
Style guide
People
People
Obituaries
Diversions
Audio and video
Audio and video library
Audio edition
Research tools
All research tools
Articles by subject
Backgrounders
Economics A-Z
Special reports
Style guide
Country briefings
All country briefings
China
India
Brazil
United States
Russia

Print edition November 8th 2008

Great expectations
Barack Obama has won a famous victory. Now he must use it wisely: leader



Previous print editions

Nov 1st 2008
Oct 25th 2008
Oct 18th 2008
Oct 11th 2008
Oct 4th 2008

More print editions and covers »

Subscribe

Subscribe to the print edition
Or buy a Web subscription for full access online
RSS feeds
Receive this page by RSS feed

Middle East & Africa

Europe

Britain

Articles flagged with this icon are printed only in the British edition of *The Economist*

International

Books & Arts

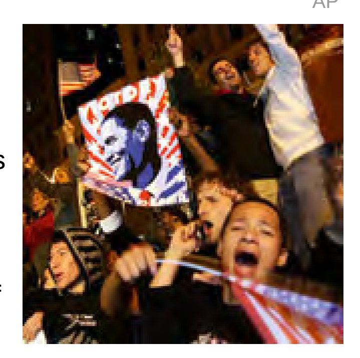
Obituary

Economic and Financial Indicators

Politics this week

Nov 6th 2008
From The Economist print edition

AP



Barack Obama won America's presidential election, beating John McCain by 52% to 46%. During a momentous night, the Democrat swept to victory in almost all the battleground states, including Florida and Ohio. Indiana and Virginia voted for a Democratic presidential candidate for the first time since 1964. As hundreds of thousands of his supporters celebrated, Mr Obama said that "change has come to America". Mr McCain conceded gracefully, praising his rival and offering him his full support. See article

In **Congress**, the Democrats increased their majority in the House and picked up at least five seats in the Senate, which would leave them at 56, four short of a 60-seat filibuster-proof majority. Despite his recent conviction on corruption charges, Ted Stevens looked likely to hold on to his Senate seat in Alaska. See article

The only **governor's office** to change hands was in Missouri, which fell to the Democrats. In Washington state, Christine Gregoire managed to fend off a challenge from her long-standing Republican nemesis, Dino Rossi. California approved a constitutional **ban on gay marriage**, which will nullify a ruling handed down in May by the state Supreme Court that legalised gay weddings. See article

Building bridges

Chen Yunlin, head of the Chinese organisation dealing with **Taiwan**, visited the island, becoming the most senior mainland official to do so since 1949. He met President Ma Ying-jeou and signed various agreements, including several that will lead to a big increase in direct transport links between the two sides. See article

General Toshio Tamogami, head of **Japan's** air force, lost his job after writing an essay seeking to justify Japan's role in the second world war. See article

Najib Razak won enough nominations for the leadership of the United Malays National Organisation, which heads **Malaysia's** governing coalition, to ensure he will be unopposed in party elections in March. He appears almost certain to succeed Abdullah Badawi as prime minister. See article

Afghanistan's president, Hamid Karzai, said that some 40 people had been killed in an American air strike in Kandahar province in the south. On a visit to **Pakistan**, General David Petraeus, head of America's Central Command, heard complaints about missile attacks on Pakistani soil by American forces based in Afghanistan. See article

Bangladesh's Election Commission confirmed that a general election will be held on December 18th. See article

Trouble and strife

AP

General Laurent Nkunda, who leads a mainly Tutsi rebel group in north-east **Congo**, remained poised to capture Goma, the area's main town, while many thousands of civilians fled from his troops' path. The foreign ministers of Britain and France toured the region, seeking diplomatic answers. The UN's secretary-general, Ban Ki-moon, said he would hold a summit meeting in Nairobi, Kenya's capital, to bring together the presidents of Congo and Rwanda, who have been sponsoring rival rebel groups in the bad zone. See article

Algeria's 71-year-old president, Abdelaziz Bouteflika, who has ruled the country since 1999, proposed to amend the constitution by removing a stipulation that a president may be re-elected "only once".

Some 6,000 delegates, mostly fed-up former supporters of **South Africa's** ruling African National Congress, held a convention in Johannesburg and decided to inaugurate a new party, so far unnamed, next month. See article

Israel sent troops into the Gaza Strip for the first time since Hamas, the **Palestinian** Islamist movement that runs the strip, agreed to a ceasefire in June. Israel said Hamas had dug a tunnel and was planning to abduct Israeli soldiers. Six Palestinian fighters were killed. Hamas fired a salvo of rockets at cities in southern Israel.

Iran's parliament sacked the interior minister, Ali Kordan, an ally of President Mahmoud Ahmadinejad, for falsely claiming to have an honorary degree from Oxford University.

Missile spat

In his first state-of-the-nation address, **Russia's** president, Dmitry Medvedev, threatened to place short-range missiles in the exclave of Kaliningrad in retaliation for America's planned missile defences in Poland and the Czech Republic. He also blamed the Americans for causing the August war in Georgia, and proposed extending the presidential term from four to six years. See article

At Russia's urging, the presidents of Armenia and Azerbaijan promised a new joint effort to resolve their dispute over **Nagorno-Karabakh**, an Armenian-controlled enclave in Azerbaijan. The war in Georgia has made all parties think twice about the risk of a new war over Karabakh, where 25,000 people were killed in fighting in the early 1990s.

A fiery death

AFP

Mexico's interior minister, Juan Camilo Mouriño, and a former anti-drug prosecutor were among nine people killed when the executive jet they were travelling in crashed into a Mexico City street, killing at least five people on the ground, injuring 40 others and setting fire to a dozen cars. Officials said the crash appeared to be an accident rather than sabotage. Mr Mouriño was a close friend and adviser of President Felipe Calderón, whose government is battling drug gangs.

Colombia's army commander, General Mario Montoya, resigned. Last month 20 senior army officers were sacked over claims that they had killed scores of civilians and passed them off as guerrillas to inflate body counts.

Bolivia's president, Evo Morales, suspended the operations of the United States' Drug Enforcement Administration, accusing its agents of espionage. This forms part of a tit-for-tat deterioration in relations that saw the American ambassador expelled last month and an American decision to suspend duty-free access for Bolivian exports. See article

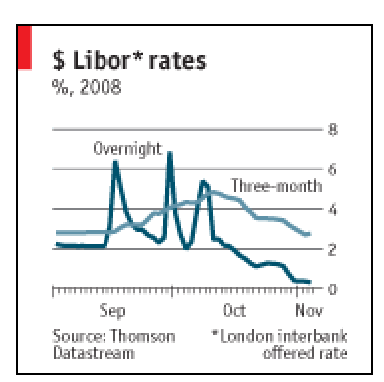
A Venezuelan, Franklin Durán, was convicted in Miami of acting as an illegal foreign agent in trying to buy the silence of a man who was stopped at Buenos Aires airport last year while carrying a suitcase containing $800,000. The court heard that the cash was part of a $5m donation from **Venezuela's** government to the election campaign of Cristina Fernández de Kirchner, who was elected Argentina's president last year.

Business this week

Nov 6th 2008
From The Economist print edition

Amid signs of a worsening British economy, the **Bank of England** slashed its benchmark interest rate by one-and-a-half percentage points to 3%, its lowest level since 1955. Earlier, Gordon Brown said he hoped banks would pass on interest-rate reductions to mortgage-holders. The **European Central Bank** reduced rates by half a point, to 3.25%. See article

Give us some credit



Interbank loan rates continued to fall, an indication that last month's severe squeeze in the money markets has eased. The three-month dollar Libor dipped to its lowest level this year. Banks, however, remained reluctant to extend credit. The Federal Reserve, in its quarterly survey of loan officers, reported that financial firms have been sharply tightening their criteria for consumer and business lending

Kohlberg Kravis Roberts delayed its intended initial public offering until next year. In July the private-equity firm unveiled a complex proposal through which it would have listed on the New York Stock Exchange by the end of 2008. Almost 250 flotations worldwide have been put on hold since the start of the year.

Commerzbank received an €8.2 billion ($10.5 billion) infusion from the German government, the first company to obtain cash directly from a German general rescue fund set up amid a wave of bail-outs in Europe last month. Germany's second-largest bank might not pay dividends in 2009-10; it definitely won't pay bonuses in 2008-09.

Far from over

MBIA and **Ambac**, America's largest bond-insurers, reported respective quarterly net losses of $807m and $2.3 billion. Both companies had their much-coveted AAA credit ratings downgraded earlier this year.

Swiss Re surprised investors by making a SFr304m ($283m) loss in the quarter. The company, which insures the insurers against market risk and natural disasters, has booked $3 billion in write-downs over the past year, but up until now had managed to turn a profit.

UBS hinted at "encouraging signs for net new money" in its core wealth- and asset-management businesses since receiving a government bail-out in mid-October. But the Swiss bank also forecast that it expects to declare another sizeable quarterly loss.

Brazil's **Itaú** and **Unibanco** agreed to merge, creating Latin America's biggest bank and one of the biggest in the world. More consolidation among banks in Brazil is expected. See article

Machinists at **Boeing** accepted revised contract terms and returned to work after a two-month strike. With production estimated to take at least two weeks to get back to normal, the test-flight programme of Boeing's 787 Dreamliner will have to be pushed back (again). It also emerged that thousands of fasteners on the new aircraft have not been properly attached.

Antitrust officials from the European Union raided the offices of several large **cement** companies, including Lafarge, Holcim and Mexico's Cemex, as part of an investigation into an alleged cartel.

There was further confirmation that **America's economy** has entered a downturn after an initial official estimate that GDP had decreased by 0.3% in the third quarter at an annual rate. Orders for manufactured goods in September fell again, following a downward revision to August's figure. Meanwhile, Circuit City, a

big electronics retailer, said it would cut about 17% of its workforce and close 155 of its stores ahead of the Christmas season.

Google's ad enough

Google backed out of a partnership agreement on advertising with Yahoo! after America's Justice Department threatened to file an antitrust lawsuit on the ground that the deal made the companies "collaborators rather than competitors". The department's decision is a blow to **Yahoo!** which, to protests from some investors, rejected a takeover approach from Microsoft earlier this year (there is speculation that Microsoft might make a new offer).

Panasonic talked to **Sanyo** about a merger. Panasonic is charged up by Sanyo's business of making car batteries for use in hybrid and electric cars. A deal, if successful, would create Japan's biggest electronics company.

Stockmarkets in America recorded their biggest election-day gains in 24 years. On November 4th the Dow Jones Industrial Average and NASDAQ indices both closed more than 3% higher; the S&P 500 was up by 4% (they fell back after the election, as optimism gave way to pessimism about the world economy). Historically, the election of a first-term president usually results in a rally during November. One notable exception came amid the controversial election of George Bush in November 2000; the S&P 500 fell by 8% that month.

KAL's cartoon

Nov 6th 2008
From The Economist print edition

Illustration by KAL



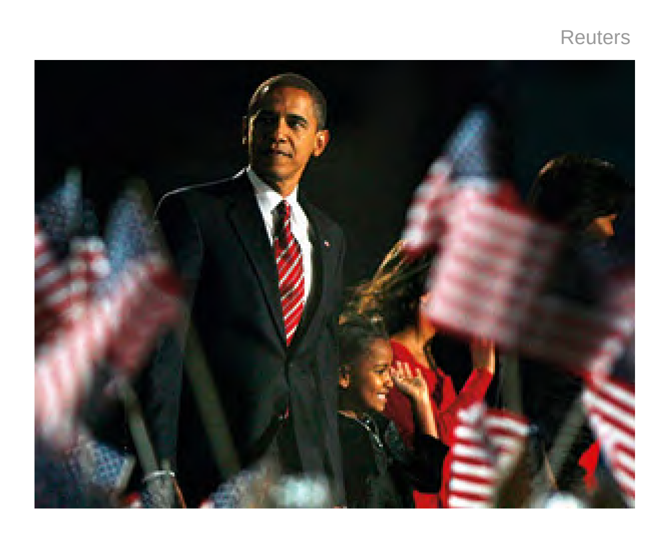
 

Great expectations

Nov 6th 2008
From The Economist print edition

Barack Obama has won a famous victory. Now he must use it wisely

Reuters



NO ONE should doubt the magnitude of what Barack Obama achieved this week. When the president-elect was born, in 1961, many states, and not just in the South, had laws on their books that enforced segregation, banned mixed-race unions like that of his parents and restricted voting rights. This week America can claim more credibly than any other western country to have at last become politically colour-blind. Other milestones along the road to civil rights have been passed amid bitterness and bloodshed. This one was marked by joy, white as well as black (see article).

Mr Obama lost the white vote, it is true, by 43-55%; but he won almost exactly same share of it as the last three (white) Democratic candidates; Bill Clinton, Al Gore and John Kerry. And he won heavily among younger white voters. America will now have a president with half-brothers in Kenya, old schoolmates in Indonesia and a view of the world that seems to be based on respect rather than confrontation.

That matters. Under George Bush America's international standing has sunk to awful lows. This week Americans voted in record-smashing numbers for many reasons, but one of them was an abhorrence of how their shining city's reputation has been tarnished. Their country will now be easier for its friends to like and harder for its foes to hate.

In its own way the election illustrates this redeeming effect. For the past eight years the debacle in Florida in 2000 has been cited (not always fairly) as an example of shabby American politics. Yet here was a clear victory delivered by millions of volunteers—and by the intelligent use of technology to ride a wave of excitement that is all too rare in most democracies. Mr Obama showed that, with the right message, a candidate with no money or machine behind him can build his own.

Hard times and a bleak House

With such a great victory come unreasonably great expectations. Many of Mr Obama's more ardent supporters will be let down—and in some cases they deserve to be. For those who voted for him with their eyes wide open to his limitations, everything now depends on how he governs. Abroad, this 21st-century president will have to grapple with the sort of great-power rivalries last seen in the 19th century (see article). At home, he must try to unite his country, tackling its economic ills while avoiding the pitfalls of one-party rule. Rhetoric and symbolism will still be useful in this; but now is the turn of detail

and dedication.

Mr Obama begins with several advantages. At 47, he is too young to have been involved in the bitter cultural wars about Vietnam. And by winning support from a big majority of independents, and even from a fair few Republicans, he makes it possible to imagine a return to a more reflective time when political opponents were not regarded as traitors and collaboration was something to be admired.

Oddly, he may be helped by the fact that, in the end, his victory was slightly disappointing. He won around 52% of the popular vote, more than Mr Bush in 2000 and 2004, but not a remarkable number; this was no Roosevelt or Reagan landslide. And though Mr Obama helped his party cement its grip on Congress, gaining around 20 seats in the House of Representatives and five in the Senate, the haul in the latter chamber falls four short of the 60 needed to break filibusters and pass controversial legislation without Republican support (though recounts may add another seat, or even two). Given how much more money Mr Obama raised, the destruction of the Republican brand under Mr Bush and the effects of the worst financial crisis for 70 years, the fact that 46% of people voted against the Democrat is a reminder of just what a conservative place America still is. Mr Obama is the first northern liberal to be elected president since John Kennedy; he must not forget how far from the political centre of the country that puts him.

Mr Obama's victory, in fact, is almost identical in scope to that of Bill Clinton in 1992; and it took just two years for the Republicans to sweep back to power in the 1994 Gingrich revolution. Should President Obama give in to some of the wilder partisans in Congress, it is easy to imagine an ugly time ahead—and not just for the Democrats in the 2010 mid-term elections. America could fatally lapse into protectionism, or re-regulate business and finance to the point at which innovation is stifled, or "spread the wealth" (to quote the next president) to the extent that capital is prudently shifted overseas.

Our mutual friends

Mr Obama will not take office until January 20th, but he can use the next ten weeks well. A good start would be to announce that he will offer jobs to a few Republicans. Robert Gates, Mr Bush's excellent defence secretary who has helped transform the position in Iraq, ought to be kept in the post for at least a while. Sadly, Richard Lugar has ruled himself out as secretary of state; but Chuck Hagel, senator for Nebraska, is another possibility for a defence or foreign-policy job. Mr Obama might even find a non-executive role for John McCain, with whom he agrees on many things, especially the need to tackle global warming and close Guantánamo. Another pragmatic move would be to announce that his new treasury secretary (ideally an experienced centrist such as Larry Summers or Tim Geithner) will start working closely with Hank Paulson, the current one, immediately.

Whoever he appoints, Mr Obama will be constrained by the failing economy. He should not hold back from stimulus packages to help America out of recession. But he has huge promises to keep as well. He has pledged tax cuts to 95% of families. He has proposed near-universal health care—an urgent reform, as America's population ages and companies restrict the health insurance they offer. He proposes more spending on infrastructure, both physical and human. But if he is to tackle all or any of this, he must balance his plans with other savings or new revenues if his legacy is not to be one of profligacy and debt. He has to start deciding whom to disappoint.

Non-Americans must also brace for disappointment. America will certainly change under Mr Obama; the world of extraordinary rendition and licensed torture should thankfully soon be gone. But America will, as it must, continue to put its own interests, and those of its allies, first. Withdrawing from Iraq will be harder than Mr Obama's supporters hope; the war in Afghanistan will demand more sacrifices from Americans and Europeans than he has yet prepared them for. The problems of the Middle East will hardly be solved overnight. Getting a climate-change bill through Congress will be hard.

The next ten weeks give Mr Obama a chance to recalibrate the rest of the world's hopes. He could use part of his transition to tour the world, certainly listening to friends and rivals alike but also gently making clear the limits of his presidency. He needs to explain that, although his America will respect human rights and pay more heed to the advice of others, it will not be a pushover: he must avoid the fate of Jimmy Carter, a moralising president who made the superpower look weak.

Like most politicians, Mr Obama will surely fail more than he succeeds. But he is a man of great dignity, superior talents and high ideals. In choosing him, America has shown once again its unrivalled capacity to renew itself, and to surprise.

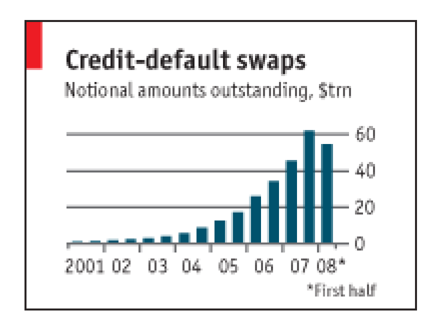
Economist.com


Derivatives

Giving credit where it is due

Nov 6th 2008
From The Economist print edition

The credit-default swap needs reform, not abolition



FINANCIAL innovations tend to go through four phases. At first, they are hailed as proof of the brilliance of the bankers who devised them. Then they succumb to rampant speculation, as investors try to exploit them. And that leads to revulsion, as a crisis causes widespread losses. The question is: should the fourth phase be rejection or rehabilitation?

The latest innovation to pass through the cycle is the credit-default swap or CDS. Despite its forbidding name, the CDS is a simple idea: it allows an investor to buy insurance against a company defaulting on its debt payments. When it was invented, the CDS was a useful concept because more people felt comfortable owning corporate debt if they could eliminate the risk of the issuer failing. The extra appetite for debt helped lower the cost of capital.

But any insurance contract requires someone to take the other side of the bargain, and that person will often be a speculator. Even a dull-sounding insurance company that sells you fire cover is in effect speculating that your house will not burn down. Insurers have lots of historical data to fall back on when setting their premiums—and even then many have gone bust in the past. Sellers of CDSs had no such record to consult. Indeed the past has been no guide to the future of CDSs, because the corporate-debt market has been transformed over the past 20 years as investors have chased yield by lending to less creditworthy borrowers.

As with previous innovations, speculation on the health of companies soon swamped the need for insurance that was the market's original purpose. CDS contracts were worth $62 trillion at the peak, far more than the bonds the CDSs were insuring. Companies like AIG, a giant American insurer, wrote far too many contracts. Wild swings in the cost of bond insurance may have helped hasten the demise of investment banks like Bear Stearns and Lehman Brothers because they found it harder to raise new capital in the teeth of the crisis. When Lehman failed it looked as if the market was unsafe: Lehman not only issued its own debt (the basis for lots of Lehman CDSs), but it was also an important dealer in those of other companies—party to perhaps 7-10% of all the trades in the market.

Plenty of people (including the New York insurance commissioner) have concluded that the fourth phase for CDSs is now obvious: rejection. They want the market to meet tight new regulations, such as requiring that any buyer of a CDS should have an interest in the underlying bond.

In fact, rehabilitation makes more sense. With a bit of nudging, the market is reforming itself. At the moment, trades are settled directly, leaving participants exposed to the failure of the other party. A central clearing house would have reduced the damage of Lehman's collapse by around two-thirds, according to a report by Moody's, the ratings agency.

Even without a clearing house, the market survived both the demise of Lehman and the earlier (largely technical) default of Fannie Mae and Freddie Mac, the two housing giants. The potentially complex procedure for settling the trades worked, without wrecking other firms; Moody's reckons the Lehman-related losses were widely spread. If banks and investors learn anything from the crisis, it is that they will make sure the firms they deal with can meet their side of the bargain.

A Betty Ford clinic for derivatives

Doubtless, the CDS market has caused immense problems, largely because no one was sure of the extent of investors' exposure. Had AIG as well as Lehman gone bust, the market might have collapsed.

The failure of another big bank would still put the system under strain, but the CDS market would not be alone. And remember that the default of big bond issuers disrupted the system long before anybody had thought of inventing the CDS.

Every bubble sees excesses; it seems odd to single out the CDS. Think back to the crash of 1987 when fingers pointed at the equity-futures market, which institutions were using to protect against falls in their share portfolios. It was argued that this exacerbated the crash. A commission was established; restrictions were imposed. Twenty years later, the Chicago equity futures and options market is vast: some $45 trillion of contracts traded on the S&P 500 index alone last year compared with the total American stockmarket value of just $10 trillion. But equity futures are unnoticed and unblamed in the crisis.

In 20 years the CDS may well be as little remarked as the equity future is now. But only with reform. As well as a clearing house, the market must be more transparent. Banks and other quoted firms should reveal how exposed they are to the market. CDSs have their uses. There is no reason why investors should not speculate in corporate debt if they can speculate on equities, currencies, commodities and the rest.





Climate change

Green, easy and wrong

Nov 6th 2008
From The Economist print edition

Why a verdant New Deal would be a bad deal

Eyevine



TWO pressing problems face the world: economic meltdown and global warming. Conveniently, a solution presents itself that apparently solves both: governments should invest heavily in green technology, thus boosting demand while transforming the energy business.

This notion is gaining credence around the world. Last month the United Nations called for a "Global Green New Deal". But it is in America that the idea is really taking off. The United States Conference of Mayors reckons that green investment should provide 2.5m jobs. The Centre for American Progress, a leftish think-tank, thinks $100 billion worth of spending in the area would spawn 2m jobs. The new president tops both. Barack Obama proposes spending $150 billion over ten years, thus helping, he says, to create 5m jobs.

There is a historical parallel to this synergy between two worthy aims. Just as military spending at the end of the 1930s defeated both fascism and the Depression, so spending on fighting climate change should both wean mankind off fossil fuels and avert what might otherwise turn into the most serious downturn since the 1930s. Isn't that neat?

No. Mr Obama's commitment to solving climate change is devoutly to be welcomed. There is also a case for giving the economy a boost through government spending. But combining the two by subsidising renewable energy is, like many easy answers, the wrong solution.

Governments can discourage companies and people from producing CO_2 by making polluters pay or by reducing the costs of clean energy. Europe does both, through a cap-and-trade system (which caps CO_2 emissions and requires companies to buy permits to pollute) and through subsidies. Mr Obama is, quite rightly, planning to introduce a cap-and-trade system, but he is also promising massive subsidies.

Making polluters pay is unpopular with companies. Politicians don't much like it either, because it means a fight with business. But it's the efficient way to discourage pollution, because it shifts costs onto those who should bear them, and allows the market to pick the best way of cutting emissions.

Sunless solar and the biofuels bust

Subsidies are more popular but both theory and practice argue against them. Subsidising clean energy requires politicians to decide on the best way of delivering it, and their judgment is likely to be worse than the market's. America's huge ethanol subsidies, for instance, have led to overinvestment in the

businesses, which is now experiencing a sharp bust, and have helped drive up the price of food, with painful consequences for the world's poor. Germany's generous solar subsidies covered the roofs of one of the world's most sunless countries with solar cells, thus pushing up the price of silicon and reducing the cost-effectiveness of solar power in countries where it actually makes sense. Both subsidies promoted the wrong technologies; both wasted taxpayers' money.

The easy notion that there is a single solution to the world's economic and climatic problems is, thus, a dangerous one. Yet there is a synergy, though a subtler one, between the two issues. In the midst of a financial crisis seen as emanating from Wall Street, a demonstration of leadership would help burnish "Brand America". Combating climate change, which demands technological and financial resources of the sort that only America has, offers the right sort of challenge.

The world needs America to lead the fight against climate change. But if Mr Obama goes about it the easy way, rather than the right way, he will discredit the cause he espouses, and thus damage the planet instead of saving it.

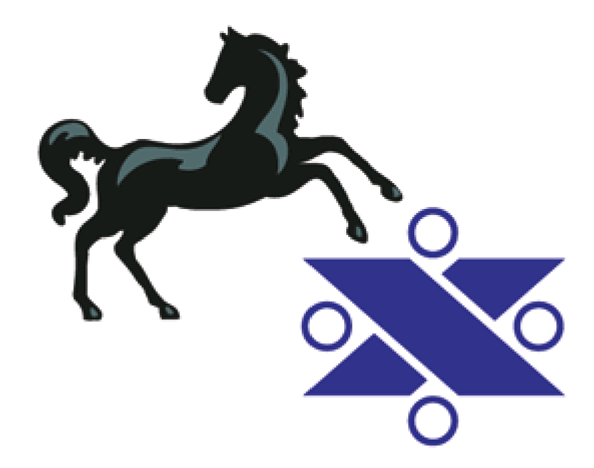



British bank mergers

Call it off

Nov 6th 2008
From The Economist print edition

Letting Lloyds TSB proceed with its takeover of HBOS is a mistake



IT WAS a desperate attempt to stem financial panic, and it worked a treat. As banks, house prices and stockmarkets all tumbled in mid-September, news that Britain's government had brokered a rescue of its biggest mortgage lender, troubled HBOS, by the relatively sturdy Lloyds TSB revived spirits no end. No matter that the deal would weld the country's fourth and fifth biggest banks, by assets, into its biggest retail-banking outfit: ministers argued correctly that saving the financial system was more important than fussing about competition.

Six weeks on, things look different—or at least they should. The government has slung a £400 billion ($650 billion) safety net under all the banks. This includes making available some £50 billion to those that cannot otherwise boost their capital to prudent levels, taking stakes in them in exchange. HBOS, which was formed from the merger of the Halifax, a former building society, with the Bank of Scotland, would presumably be as entitled to government support on its own as is, say, the wounded Royal Bank of Scotland (RBS). Yet the £17 billion earmarked for HBOS and Lloyds TSB is said to be dependent on their merger—and on October 31st the new business secretary, Lord Mandelson, disregarded the recommendations of some HBOS shareholders, many Scottish politicians and the official competition watchdog, the Office of Fair Trading (OFT), and waved through the deal. He made the wrong call.

Few deny that HBOS will need state support. The bank's huge funding needs are impossible to meet at a time when credit is globally scarce. Its many mortgage loans are looking increasingly seedy as the British economy turns down. HBOS would need an extra £11 billion or so to hit stringent new capital requirements. And talk of a rival private-sector bid (see article) has so far got nowhere.

But there is a world of difference between rescuing a stand-alone HBOS and rescuing it as a subset of Lloyds TSB. The government may think that Lloyds's managers, who have taken seven of the top nine jobs so far, would make better use of HBOS's assets than an independent management would. It may also reckon that a bigger bank would be more likely to redeem the government's preference shares quickly and turn a tidy profit for the taxpayer when the ordinary shares are sold: Lloyds plans to strip out £1.5 billion from costs (by, presumably, closing branches and laying off workers). But a new banking behemoth would also reduce competition significantly.

The OFT made this clear on October 31st, when it published a sober analysis of a merged Lloyds and HBOS. The combined banks would have around 30% of personal current accounts, about the same share of mortgages and 40-50% of small-business services in Scotland—strengthening a duopoly with RBS that already exists there. While the Halifax challenged the established high-street banks, lowering prices and offering new services, the new Lloyds-HBOS will surely be tempted to go for the easier option of raising

rates for its existing customers. British retail banking is already concentrated; barriers to entry—a branch network, a solid reputation—are high; consumers are slow to switch providers. So far the only clear advantage of the deal to consumers is the knowledge that HBOS will not go bust—and that is something now covered by the government's new bail-out arrangements.

Future perfect

It is a shame that the bid was not referred, as the OFT urged, to the Competition Commission for more study. Lord Mandelson's instruction to the OFT to keep the banking sector "under review" is no comfort: it has done so for years, yet banks nonetheless fail to serve consumers well in some ways. The point of controlling mergers at the outset is that, once consummated, they cannot easily be undone, nor behaviour changed.

Shareholders may still stop the deal. Lloyds TSB's are due to vote on it on November 19th and, if they approve it, HBOS's after that. But investors may well be reassured by the prospect of uncompetitive profits that made regulators queasy.

To be fair to Lord Mandelson, bank bail-outs always involve an agonising balancing act: systemic stability versus moral hazard; fighting recession by lending to small businesses versus safeguarding the taxpayer's investment; and so forth. But it is necessary to look beyond the immediate horror story. When this crisis is over, the financial system will work better if a healthy number of competitors are still standing. A stand-alone HBOS preserved in the near term could find its own feet then, or be sold to a bidder with which there is less overlap. When goals conflict, competition is the surest lodestar.

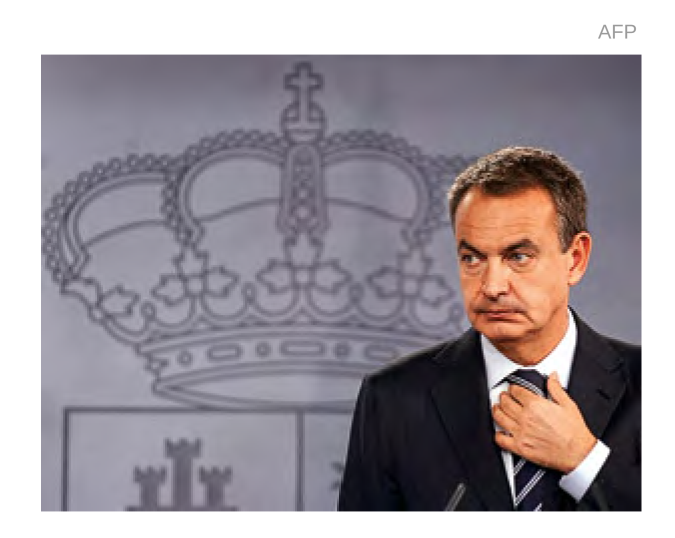
Spain

After the fiesta

Nov 6th 2008
From The Economist print edition

A European success story; but it is time for José Luis Rodríguez Zapatero to step outside his comfort zone

AFP



GROUCHO MARX got it wrong when he said that he didn't care to belong to any club that would have him as a member. There are in fact few things in life so wounding to self-esteem as to be excluded from a gathering where you think you rightly belong. In an attempt to avoid such a fate, José Luis Rodríguez Zapatero, Spain's prime minister, has cast dignity aside and importuned all and sundry with a request to be invited to a conference on November 15th to discuss reforms to the international financial system. The brainchild of France's Nicolas Sarkozy and of America's George Bush, the conference will be attended by the G8 economies and 12 large developing countries. Spain belongs to neither group.

Whether or not the conference proves to be important, Mr Zapatero is right that he deserves to be there. Spain is the world's ninth-largest economy at market exchange rates, or twelfth when measured by purchasing power (making it bigger than Canada, a G8 member). It is the world's seventh-biggest foreign investor. It has two of the 20 biggest banks, and it has made a good job of regulating its banking system (see our special report). Like the United States, Britain and Ireland, Spain has seen a runaway housing boom turn to bust over the past year. Unlike them, none of its banks has yet had to be bailed out. Indeed, Banco Santander has been shovelling up banking roadkill in Britain and the United States.

So Spain has something to say in any discussion about global finance. Its non-invitation may owe something to Mr Bush's puerile sulk at Mr Zapatero over his abrupt withdrawal of troops from Iraq in 2004. But if Spain is too easily overlooked, it is partly Mr Zapatero's fault. He is one of Europe's few successful politicians of the left. Underestimated by his opponents at home, he was re-elected to a second term earlier this year. But he has shown little interest in the world beyond Spain. In this parochialism he faithfully represents a country where decentralisation has brought benefits but narrowed political horizons. That does not reduce its potential cost.

La cuenta, señores

In the three decades since it emerged from dictatorship Spain has become one of the world's success stories. It has turned into a robust democracy and a tolerant society. Until recently it was creating one of every three new jobs in the euro area. But too many of those jobs involved building more than a third of all the new houses started each year in the euro zone. The housing bust at home, as much as the financial turmoil abroad, has sent Spain skidding towards recession. For an economy that has been growing at close to 4% a year for a decade, this is a painful experience. Already this year unemployment

has shot up by 750,000 to 2.8m, or 12.3% of the workforce.

After initially downplaying it, Mr Zapatero has responded reasonably effectively to the slowdown. The government has announced measures to inject liquidity; the unemployed will be able to postpone part of their mortgage payments. But the test will be whether the prime minister takes the steps needed to make the recession as short and mild as possible. These include structural reforms, especially of the labour market, to address Spain's growing loss of competitiveness—it is no longer a cheap place to do business, and its workers are not especially productive. He may also have to claw back money and regulatory power from the regional governments. That is not easy, since the electoral system gives exaggerated weight to Basque and Catalan nationalists. Like some of its predecessors, the government is dependent on their support to pass its budget. And as foreign investment heads elsewhere, Mr Zapatero needs to sell his country more aggressively abroad.

In contrasting ways both of his predecessors, Felipe González and José María Aznar, carved out a role for Spain as an important actor in Europe and as a bridge to the Americas. History may judge that Mr Zapatero was right to oppose the war in Iraq. But under him and his foreign minister, Miguel Angel Moratinos, Spain's foreign policy has resembled the pleadings of an NGO rather than the cool-headed pursuit of national interest by a country which wants to be treated as a world leader. In his first term, Mr Zapatero's main initiative was a worthy but nebulous "Alliance of Civilisations". In his second term he has set as a goal the worldwide abolition of the death penalty.

Mr Zapatero has proved himself a skilled political tactician. But he has shown no willingness to lead his Socialist Party out of its politically correct comfort zone. If Spain's remarkable success is not now to be followed by stagnation and limited international relevance, he will have to do so.

Heathrow's future

The right side of the argument

Nov 6th 2008
From The Economist print edition

The British government is set on letting Heathrow airport expand. It should think again

AP



GORDON BROWN is never happier than when he believes he has forced his political opponents on to “the wrong side of the argument”. That is why he clung so stubbornly to his policy, finally foiled, of introducing 42 days’ detention without charge of suspected terrorists long after it had become abundantly clear that there was little operational need for it. What seemed to matter most to the prime minister was that the opposition Conservatives could be portrayed as putting wishy-washy concepts of civil liberty before national security.

Mr Brown is at it again now on a different issue. Before the end of the year it is almost certain that the government will approve the expansion of London’s Heathrow airport, making possible a third runway and a sixth terminal. This time he senses an opportunity to condemn the air-headed Tories for naively putting greenery above the economy. A bigger Heathrow, he will claim, is crucial to Britain’s prosperity. In fact his case seems as vapid and noxious as a jet-engine’s exhaust.

Playing politics with planes

Nobody doubts that, as things now stand, the world’s busiest international airport is full up. Because Heathrow’s two runways operate at close to capacity, even the smallest hitch can cause flight delays. Airlines want more capacity at Heathrow: scarce take-off and landing slots have recently changed hands for up to £30m ($48m) apiece. It is hardly surprising that BAA, the airport’s operator, would like to expand its most valuable property, or that British Airways, with more than 40% of Heathrow slots, thinks its own growth prospects are inextricably linked to those of the airport. But other claims made for enlarging the airport are specious or misleading.

The main one is that Heathrow must get bigger if London’s—read Britain’s—economy is not to take a hit. It is too soon to know how severely the economic downturn will pare passenger numbers. But more than a third of travellers coming into Heathrow are transfer passengers, up from just 9% in the early 1990s. True, they could be seduced away by hub airports on the continent with more capacity: Amsterdam’s Schiphol, say, or Charles de Gaulle in Paris. But so what? International transfer passengers who never leave the airport are useful to the airline industry, but they are of little wider economic value. At the margin, they may make some unpopular routes viable and increase frequency on others, but the notion that they play a vital role in connecting London with the rest of the world is not supported by the evidence. As the number of transit passengers has grown, the number of routes served out of Heathrow has actually contracted, from about 230 to 180.

If the economic case for expanding Heathrow is nothing like as compelling as the government pretends, the environmental arguments against remain as strong as ever. Because it is located in built-up west London, Heathrow already makes more people miserable than just about any other big developed-country airport. BAA and the Department of Transport have tried to show that adding a quarter of a million flights will not increase noise and local air pollution. Opponents reckon they have colluded in making up optimistic projections about the speed with which airlines will change to yet-to-be-built clean, quiet aircraft. Expanding Heathrow also sits oddly with the government's new commitment to cutting greenhouse-gas emissions by 80% by 2050.

But the biggest reason why Mr Brown should hold off deciding Heathrow's future is that the government's own Competition Commission ruled in August that BAA's monopoly of London airports should be broken up. Anticipating a direct order, the airport operator has already put up Gatwick for sale. Any new owner is likely to seek permission to build a second runway there to compete with Heathrow for business. That would give London plenty of new capacity at a lower environmental cost than expanding Heathrow. If Mr Brown wants to be on the right side of this argument, he should acknowledge that circumstances have changed and act accordingly.

On opinion polling, Central America, currency boards, confidence, Georgia, Spain, language, politics

Nov 6th 2008
From The Economist print edition

Questions and answers

SIR – Your article about the accuracy of opinion polling in America's election stated that "online surveys are notoriously biased" ("Poll, baby, poll!", October 25th). Their track record says otherwise. In the almost 80 elections in the United States and Britain where we can carry out a comparison, the final forecasts of online opinion polls have on average been somewhat more accurate than telephone polls. What's more, they include most of the "cellphone only" population.

You also wrote that "most experts" consider as "sloppy" the weighting of surveys to compensate for biases in the sample. As the raw samples in all opinion polls contain biases, whether the data are collected in person, by mail, on the phone or online, it would be very sloppy not to weight them. Who are these experts?

Humphrey Taylor
Chairman
The Harris Poll
New York

Trading partners

SIR – Your evaluation of the Honduran government's attempt to join the "anti-American" Bolivarian Alternative for the Americas attributed the decision to a presidential whim ("Zelaya plays the Chávez card", November 1st). This misses a vital point. Trade co-operation between Central America and its primary economic partner, the United States, has, for the most part, led to increased economic insecurity and inequality in the impoverished region.

Trade agreements have focused on opening Central American markets to government-subsidised exports from the United States, which drives up trade deficits and cripples the agricultural sectors of countries like Honduras. In light of the global economic downturn, Central America will probably suffer from a drastic reduction in direct investment from companies in the United States, as well as a drop in demand for its exports. Under these circumstances, it comes as little surprise that Honduras would seek to align itself with an alternative economic block for a shot at prosperity that the United States has failed to deliver.

Mary Tharin
Research associate
Council on Hemispheric Affairs
Washington, DC

Currency pegs

SIR – Your briefing on the implications of the financial crisis for eastern Europe got it exactly backwards when discussing the role of currency boards ("Who's next?", October 25th). You said that the "main disadvantage" of such arrangements is that they limit the "flexibility" of policymakers. However, the point of these measures is to restrain the ability of politicians to muck around with the money supply.

Such "limits" are an advantage even in tough economic times because they are a credible signal of the commitment of a government to keep politics out of monetary policy. Thus, if the Baltic states were to float their currencies the "catastrophic humiliation" would be less important than the "catastrophic" signal

it would send to investors worldwide: that their governments cannot be trusted to keep their promises.

Andrew Morriss
Professor of law and business
University of Illinois
Champaign, Illinois

Believing is everything

SIR – It is very troubling that there are efforts being made to punish overconfident banking executives, who issued upbeat public statements as their balance sheets deteriorated ("Hunting for scalps", October 25th). Regulators would be doing investors a horrible disservice if they set a precedent discouraging such confidence-building measures from financial companies, which rely on the faith of the market in order to survive. Furthermore, government officials searching for scapegoats in this matter should take a long look in the mirror. The history of government economic policy is full of examples of public pronouncements intended to restore confidence when little confidence was warranted.

Perhaps the most famous example is that of Norman Lamont. As Britain's chancellor in 1992 Mr Lamont insisted until the bitter end, on Black Wednesday, that the pound would not be devalued and Britain would remain in the European exchange-rate mechanism. Ironically, such statements by government ministers are often the best sign that the trouble is real.

Brian Smith
Norwalk, Connecticut

Russia and Georgia

SIR – Although it may appear that Russia baited Mikheil Saakashvili into making an aggressive move in its conflict with Georgia, your briefing alluded to the fact that observers from the Organisation for Security and Co-operation in Europe heard no Ossetian shelling before Georgian forces started their assault ("After the war", October 18th). Pushed or not, Georgia's president would not have fallen for the bait if he were not reckless and willing to gain control by force of a territory that does not want to be part of Georgia.

Nothing in the Caucasus is cut and dried. Ossetians have seen Russia as their protector since Catherine II. In the 1990s Georgians carried out ethnic cleansing against the Abkhaz. The Abkhaz, with Russian help, returned the favour. Now that Russian troops have withdrawn from Georgia, the best course is to go back to business as usual with Russia and see if Georgia can get its domestic political act together.

Germany and Italy are right. It is not reasonable to expect Russia just to put things back the way they were prior to August 7th. And, as you pointed out, the Georgians may create such a good domestic situation that the South Ossetians and Abkhaz will want to be a part of it.

John Barnhart
Roanoke, Virginia

The past is not quite past

SIR – History is a double-edged sword ("Ghost story", October 25th). One can imagine that once Judge Baltasar Garzón has finished pursuing General Francisco Franco, who died in 1975, he will start holding other political leaders accountable for crimes against humanity: Pol Pot, Stalin, Mao Zedong. Should we also include Napoleon Bonaparte on the list? The belief that those who took part in the repression during Spain's civil war and are still alive should stand trial is also applicable to the members of the death squadrons on the Republican side.

José Miguel de la Viuda
Toulouse, France

Free speech

SIR – There are many reasons not to fear the evolution of languages ("When nobody understands", October 25th). Historically, languages were propelled by nation states willing to reinforce their power. For example, the Académie Française has been used as an essential part of French absolutism since 1635. The evolution of languages around the globe today is spontaneous, cutting against the state's coercive power.

Quentin Michon
Blackrock, Ireland

Taking a tumble

SIR – One of your recent covers on the global financial crisis depicted a man peering over a crumbling cliff (October 4th). It reminded me of the joke where a politician boasts: "Before I came to power, we were at the edge of a great chasm. But since then, we have taken a big step forward." Let's hope this remains just a joke.

Peter Paelinck
Merrimack, New Hampshire

Challenges facing Barack Obama

Obama's world

Nov 6th 2008
From The Economist print edition

How will a 21st-century president fare in a 19th-century world?



BLISS it is in this dawn to be alive. That will be the reaction of many people around the world to America's election of a thrilling new president—young, black, with political and intellectual gifts well above the ordinary. But the world that will face Barack Obama when he moves into the White House in January is not very heaven. It is, in fact, a mess.

In his 2006 book, "The Audacity of Hope", Mr Obama wrote of America's need to build a new international consensus to confront transnational threats. The world of great-power rivalry, he argued, "no longer exists". But is that true? An argument can be made that old-fashioned competition between the powers has come back with a vengeance since the fleeting post-Soviet interlude of the 1990s, when America bestrode the planet unopposed. As Robert Kagan, one of America's cleverest (and pro-McCain) foreign-policy intellectuals, notes in his book "The Return of History and the End of Dreams", a 19th-century diplomat would instantly recognise this new-old world of clashing interests and alliances between great powers.

American foreign policy itself has an oddly 19th-century flavour nowadays. Embroiled in foreign wars thousands of miles from home, the Americans, like the British before them, are fighting Muslim zealots from Mesopotamia to Afghanistan and Pakistan's Hindu Kush.

This is hardly the agenda Mr Obama would have chosen for himself. A courteous and cerebral Harvard-educated lawyer, with a gift for inspiring and uniting people from the most diverse of backgrounds, he looks like the conciliator needed to co-ordinate a rescue of the world economy, tackle climate change, reform global institutions and, above all, revive America itself. But a new president cannot pick the place his story starts. "You may not be interested in war," Trotsky once said, "but war is interested in you." Thanks to the legacy bequeathed by Osama bin Laden and George Bush, Mr Obama will begin his term as a war president, one who has promised to end the war in Iraq but to win the one in Afghanistan. These, no less than digging America out of recession (see article), will be preoccupations from day one.

And none of it will be easy. If the 200,000 Germans who turned out to cheer Mr Obama in Berlin this summer are anything to go by, he will enjoy terrific global goodwill. But cheering Germans will not send more troops to help in Afghanistan. The world will applaud if Mr Obama closes Guantánamo, the prison that has come to symbolise everything that was wrong with Mr Bush's "war on terror". But even if he does, al-Qaeda will not dissolve itself; Michael McConnell, America's director of intelligence, has told both candidates it will remain "very lethal" for the next 20 years. Mr Obama has a resounding mandate, but

polls suggest that 60% of Americans want the new president to focus on domestic issues and only 21% on foreign affairs. And in foreign affairs he will anyway not be able to summon all the familiar, muscular instruments of power available to his predecessors: America's military machine as well as its money machine is on the rack.

One bright spot is that Mr Obama's promise to withdraw most combat forces from Iraq by May 2010 looks more achievable than it did when he started campaigning. Mr Bush's "surge" and America's exploitation of a Sunni backlash against al-Qaeda have slashed the rate of killing this year. America has at last trained a half-decent Iraqi army, which has boosted the self-confidence of Iraq's government (so much so that it might order American troops in Iraq into their barracks when America's UN mandate ends this December).

Even so, Iraq is far from stable. The present calm flatters to deceive. The government is dominated by Shias who have neither accepted a big enough place for the formerly dominant Sunnis nor resolved an explosive argument with the Kurds over the control of Kirkuk. If these flaws remain unfixed, the civil war could resume. Mr Obama may be tempted to get out while the going is good, pocketing a "victory" earned mainly on Mr Bush's watch. But too fast a rush for the exit might itself be the catalyst for new slaughter.

Mr Obama will also inherit an acute problem in Iran. He has promised to do everything in his power to stop the Iranians acquiring a nuclear bomb. Since Mr Bush's threats of force and economic sanctions did not make Iran stop enriching uranium, Mr Obama may attempt a feat of diplomatic ju-jitsu, by seeking a rapprochement instead. He says that America should be willing to talk to enemies, Iran included. And a "grand bargain" could solve many problems. Iran and America have some common interests, including regular energy exports from the Gulf, a stable Iraq and hostility to the Taliban in Afghanistan. An Iran at peace with America might abandon its nuclear ambitions, stop calling for the dissolution of Israel and end its support for groups such as Hamas in Palestine and Hizbullah in Lebanon, which also want Israel destroyed.

It is a beguiling theory. But Iran's intentions are hard to decipher. Does it prize good relations with America enough to drop its nuclear ambitions and accept Israel? How much influence would it demand in return? Or, having watched Mr Bush flounder, does it judge American power to be on the wane and see a chance to master the Middle East without conceding anything? The only certain fact is that Iran has an unsurpassed record of running circles around its interlocutors. Mr Obama will have to guard against the danger of Iran spinning out talks while also continuing to spin the centrifuges making the fuel that could be enriched for a bomb.



Caught in Afghanistan

Finishing the war in Iraq will be hard enough. Winning the one in Afghanistan may prove harder still. When Mr Obama started his presidential run, Iraq looked hopeless and Afghanistan more manageable. But now it is Afghanistan that has started to look unwinnable and to claim the bigger toll in American lives. Mr Obama can reinforce in Afghanistan by winding down in Iraq, but more troops are only part of what Afghanistan needs. Mr Bush hoped for too much and demanded too little from President Hamid Karzai. He has been a thorough disappointment, never daring to tackle the drug-traffickers and former warlords worming away his administration from within.

Afghans now consider the government in Kabul both corrupt and ineffectual, a mixture lethal to its legitimacy. Elections due in 2009 might give Mr Obama an opportunity to promote an alternative to Mr

Karzai, but no exceptional candidate has come forward. And the elections could backfire if Taliban control of the Pushtun belt prevents the majority tribe from participating and delivers power to the Tajiks. Mr Obama may hope that General David Petraeus, who took over as America's regional commander last week, can replicate in Afghanistan the counter-insurgency magic he performed in Iraq. But the general himself has said that the two insurgencies are very different.

One of the most worrying differences is Pakistan. The insurgents in Afghanistan have the advantage of a sanctuary in the lawless tribal areas across Pakistan's mountainous border. Pakistan itself is a nominal American ally that has lately gone on the blink in a way no American president can ignore. The relationship between America and Pakistan, scratchy enough when General Pervez Musharraf was president, is misfiring under the rickety civilian administration of Asif Ali Zardari, Benazir Bhutto's widower.

On the campaign trail Mr Obama promised to be tough on Pakistan, threatening to attack al-Qaeda there if he had the intelligence and the Pakistanis refused to take action themselves. This did not win him a lot of friends in this nuclear-armed country of more than 160m Muslims. He has now promised to support Pakistan's government while compelling it to take on the insurgents. But how to conjure a policy out of the sound bite?

Pakistan has a political crisis, an economic crisis, a jihadist insurgency, a coup-prone army and an intelligence service that may still have links to the Taliban. America's cross-border attacks often kill civilians and inflame anti-American sentiment. If he undermines the wobbly Mr Zardari, Mr Obama is in danger of giving al-Qaeda a far bigger prize in Pakistan than the one it lost in Afghanistan.

Calls for "engagement" in Palestine, an emblematic conflict that galvanises Muslims everywhere, follow every new president into the Oval Office. Candidate Obama reiterated America's customary support for the Jewish state (a "fundamentally just concept") and called its security sacrosanct. At the same time he has shown more sympathy than most previous presidents for the plight of the Palestinians, perhaps influenced by the friendship he formed in Chicago with Rashid Khalidi, a prominent Palestinian-American scholar.

Whether Mr Obama can transform this support for Israel and empathy for the Palestinians into a peace initiative is another matter. History suggests that presidents who tackle Palestine late in their term make no progress. And even presidents who try hard can fail. Bill Clinton's abortive summit at Camp David in 2000 haunts would-be peacemakers. In the wake of that failure a Palestinian *intifada* set Israel and the occupied territories on fire. The incoming Mr Bush took one look at the smoke and chose not to get his hands burned. And once al-Qaeda attacked America Mr Bush had too much else to do.



Gummed up in Gaza

The scene facing the incoming Mr Obama is quieter: the West Bank is locked down by Israel and in the Gaza Strip Hamas is patchily observing a truce. But conditions are not much riper for diplomacy. Israel's elections next February may return a hawkish religious-right government in place of the centrist Kadima. And whereas Yasser Arafat once spoke for most Palestinians, they are now split between Hamas and Fatah. Mr Obama may judge it wiser to concentrate first on seeking a deal with Iran—or splitting Syria from Iran by getting Israel to return the Golan Heights—than to grasp the thorn of Palestine right away.

The crescent of instability from the Levant to Pakistan consumes the present White House and will dominate the thinking of the new one. By contrast, relations with Europe will need less maintenance.

Americans like to say that, thanks in part to their efforts, Europe is at last “whole and free”, undivided by an iron curtain and with democracy ascendant everywhere. Though not yet the political power some members want it to be, the European Union has taken over the responsibilities that fell to America during the Balkan wars of the 1990s. To many in Europe the Obama presidency offers a chance to sweeten a relationship that soured under Mr Bush, and so shore up both the soft and hard power of a West in apparent decline.

And yet if Mr Obama hopes to coax bigger contingents for Afghanistan out of his NATO allies, he will have trouble. The Afghan war, not just the Iraq war, is unpopular in Europe. The Dutch (and Canadians) may leave Afghanistan soon. Even the faithful British, overstretched by the investment Tony Blair made in the “special relationship” with America, are demoralised. Europeans want to preserve NATO, but are no longer sure what it should mainly be for: Russia’s invasion of Georgia in August persuaded some members that the alliance should be preparing again to defend Europe, not taking on new responsibilities as an instrument of America’s far-flung wars against terrorism.

John McCain’s gut told him that Russia is dangerous. Mr Obama’s cautious reaction to the war in Georgia suggests that he has not yet made up his mind. That is forgivable: the world’s professional Kremlin-watchers are also still scratching their heads over how to read Russia’s swaggering demeanour under Dmitry Medvedev and Vladimir Putin. Was the invasion of Georgia evidence that Russia is on the march again, fired up by its energy riches? Or were the Russians dragged into a war they did not want by the adventurism of an American protégé, Georgia’s intemperate Mikheil Saakashvili?

Either way, America can no longer take Russia’s grudging acquiescence for granted. An ugly nationalism is abroad in Russia. It wants to be accepted again as a great power and will resist a further enlargement of NATO. With its nuclear arsenal, its threat to remobilise conventional forces, its control over gas supplies to Europe, its arms sales to the likes of Iran and Venezuela and its ability to gum up the Security Council, Russia has plenty of ways to make trouble. Its mood swings like a pendulum between feelings of victimhood and an instinct to bully—which makes it hard to strike a balance between appeasing and confronting it. America’s European allies are divided on this. Some favour a tough line; others want Mr Obama to reverse Mr Bush’s plans to base missile defences in Poland and put Georgia and Ukraine on the path to NATO membership.

How far into the future must an American president look? With two wars and a recession on his hands, Mr Obama will have less attention to devote to the slower, deeper cycles of global change. The presidency of George Bush senior coincided with the collapse of the Soviet Union. He and Mikhail Gorbachev started the process of reducing the superpowers’ nuclear arsenals—a job Mr Obama could usefully take further. That Mr Bush also started to talk and think about the need for “a new world order”, one that would reflect the profound changes ushered in by the end of the cold war. But his attention was distracted by America’s first war against Saddam Hussein, and an ailing economy contributed to his defeat by Mr Clinton in 1992.

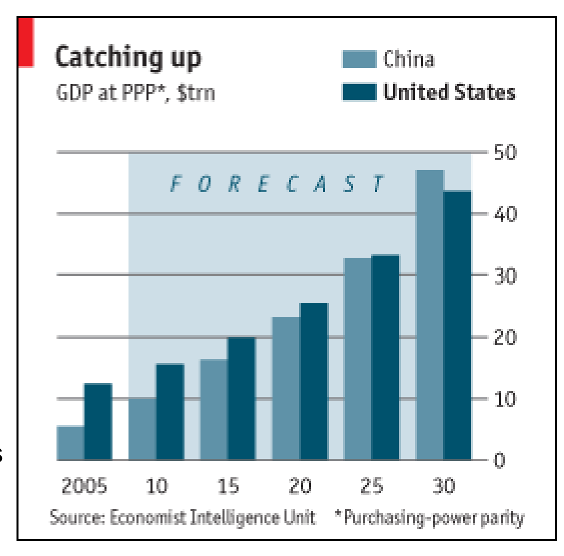
Life in the top dog yet

Mr Obama will also take office at a time of big changes in the underlying world order. The rise of Asia means that the 21st century will not be dominated as the last one was by the Atlantic powers. America, to be sure, remains the world’s strongest military force; America and the EU have the world’s biggest economies. But although the main aim for now of a China fixated on its own growing pains is to preserve stability, its economy could surpass America’s by 2030 (see chart), and America’s director of intelligence predicts that it will start to become a global military power by 2025.

That may not be long after Mr Obama’s watch. So a far-seeing president would use this transition to make certain that, by the time China does achieve its full potential, it and the world’s other rising powers are bound into what they consider a just international system in a way that enables the West to continue to prosper too. That will require not only a thorough overhaul of institutions from the United Nations to the IMF but also a change in America’s mentality: above all, a greater willingness to heed, not just hear, the views of others.

Easy to say. The economies of America and China are complementary: America borrows China’s savings to buy what

China makes. But many policy issues—trade, exchange rates and global warming—set them at loggerheads. One of the new president's big jobs will be to stop a Democratic Congress from taking refuge in protectionism and China-bashing as the American economy slumps. And one of his hardest sells will be persuading India and China to curb carbon emissions while the average American pumps four times more carbon into the sky than the average Chinese.



American co-operation with China will be hampered not just by conflicting interests but also by values. The president of the United States continues to be, as the cliché has it, the leader of the free world. Mr Obama cannot be true to his own principles or to America's vocation and simply ignore the fact that China is authoritarian, or turn the blind eye China does to gross abuses of rights in places such as Myanmar or Sudan. He dare not forget that not just Taiwan but also Japan and South Korea still depend on America to defend their freedom if China one day turns aggressive.

At the end of the 19th century, Britain was the world's superpower. By the end of the 20th it was America. The transition was preceded by two world wars. Some time in this century, the balance of power will change again. Mr Obama has inherited a world of pressing troubles. But as he tackles them he will have to keep an eye on the longer game: how to prepare for the day when America may no longer be sole superpower and only the first or maybe the second of many big powers. To manage that transition peacefully and still promote the spread of free markets and liberal democracy: that will be the mark of a truly great president for the 21st century.

The economic crisis

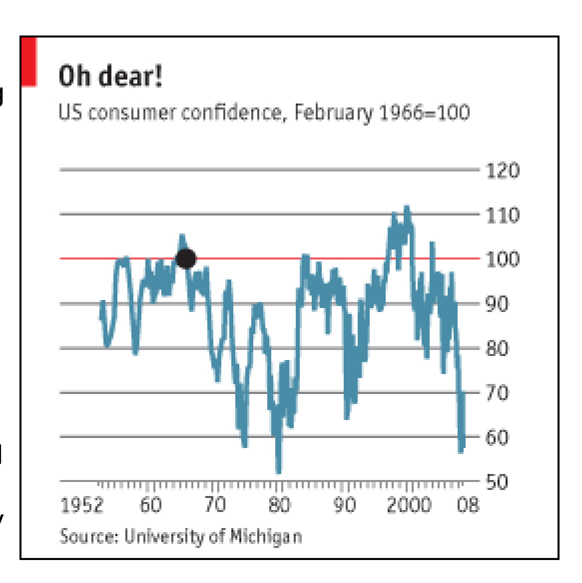
Wolves at the door

Nov 6th 2008 | WASHINGTON, DC
From The Economist print edition

Financial mess and gathering recession dominate Barack Obama's economic agenda

HE HAD always planned for the economy to be his priority. Just not this economy.

As candidate, Barack Obama crafted a platform to address the concerns that preoccupied voters earlier this year: high energy and health-care costs, stagnant middle-class incomes and rising foreclosures. But such problems pale beside the eruptions since August. America's housing crisis has become a global financial panic; the economy, which was muddling along as recently as July, may be in its deepest recession in decades. Consumer confidence, as our chart shows, is at its lowest in more than half a century (except for a brief sharp dip in 1980).



Only twice since the 1920s has economic angst played such an important role in a presidential election—and both the previous occasions make imperfect templates (see table). When Franklin Roosevelt defeated Herbert Hoover in 1932, the Depression had been going on for three years, thousands of banks had failed and unemployment was 25%. When Ronald Reagan beat Jimmy Carter in 1980, inflation had been high for years, hovering at 12% as voters headed to the polls. The current crisis has been under way for little more than a year, the first failure of a big financial institution was in March and the latest figure for unemployment (in September) was just over 6%. Inflation this year topped 5%, mostly because of soaring petrol prices, and is now heading down.

Who would want to be president?

Election transitions

Election year	Incoming president	Unemployment rate, %*	Inflation, %†	Key economic issues
1932	Franklin Roosevelt (D)	24.9	-10.7	Depression
1948	Harry Truman (D)	3.8	6.5	Post-war adjustment, labour strife
1952	Dwight Eisenhower (R)	3.1	2.3	Korean war price controls
1960	John Kennedy (D)	5.5	1.0	Fear of recession, unemployment
1964	Lyndon Johnson (D)	5.1	1.3	The Great Society
1968	Richard Nixon (R)	3.4	4.5	Civil unrest and Great Society backlash
1976	Jimmy Carter (D)	7.6	5.5	Unemployment, energy prices
1980	Ronald Reagan (R)	7.5	12.6	Inflation, energy prices
1988	George Bush senior (R)	5.4	4.2	Trade and budget deficits, tax cuts, middle-class squeeze
1992	Bill Clinton (D)	7.6	3.0	Budget deficit, NAFTA, tax increases
2000	George Bush (R)	3.9	3.5	Budget surplus, Social Security Reform
2008	Barack Obama (D)	6.1	4.9	Financial crisis, foreclosures, recession

*September †Consumer prices, percentage change on a year earlier, September

Sources: US Census Bureau; US Bureau of Labour Statistics; National Bureau of Economic Research

What distinguishes today's economic environment is that it is such a sharp break from a long period of low inflation and shallow recessions, an era lasting 26 years which some economists named "the great moderation". Indeed, the median-age voter this year has known little else, notes Michael Barone, a political expert at the American Enterprise Institute. There have been financial upsets, such as the 1987

stockmarket crash and the 2001 dotcom bust. But they lacked the destructive power of this year's financial tempest which has capsized banks, money-market mutual funds, insurers, hedge funds, car manufacturers—and countries as disparate as Iceland and Ukraine.

Against this background, Mr Obama confronts three distinct though related challenges: the financial crisis, mortgages and foreclosures, and recession. Of these, the financial mess has to be dealt with first. "Problems in the financial system", explains Douglas Elmendorf, an economist at the Brookings Institution, "evolve in a matter of hours, days and weeks."

If Mr Obama is lucky, he will take office on January 20th with financial affairs more or less under control thanks to steps taken by Henry Paulson, the treasury secretary, and the Federal Reserve. The government is buying equity in banks and guaranteeing their debt, and the Fed has dramatically expanded its lending to all manner of borrowers. There are signs of success. Stocks have risen from their lows of a week ago. Banks are growing a bit more willing to lend to each other, judging by the decline in rates on three-month interbank dollar loans (although that rate remains extremely high in relation to the Fed's target rate).

But for the healing to continue more government intervention will almost certainly be needed. As a slumping economy turns more debts bad, more financial firms will founder—and Mr Obama must decide whether to rescue them. He will press for conditions, such as lending commitments, which Mr Paulson shied away from.

The Treasury is expected to ask for the second $350 billion tranche of the $700 billion in bail-out funds. It may even need more as the list of supplicants grows. GMAC, the finance affiliate of General Motors, which said on November 5th that its mortgage unit might fail, is seeking access to the Treasury's bail-out funds. Insurers want to qualify too. Sheila Bair, chairman of the Federal Deposit Insurance Corporation, a bank regulator, is pressing for more aggressive (and costly) measures to reduce foreclosures. Some non-financial companies, such as the carmakers, will also come close to bankruptcy. Their requests for help will get a sympathetic ear from Mr Obama.

Because of the extreme fragility of market confidence, the way the presidential transition is handled is crucial. Mr Obama's preparations have been extensive and George Bush himself has prepared the ground for a smooth handover. The president-elect may name the main members of his economic team within days to reassure investors that the replacement of Mr Paulson will be seamless. Both Lawrence Summers, who held the office under Bill Clinton, and Timothy Geithner, the president of the Federal Reserve Bank of New York, are on the shortlist of candidates to take over. Mr Bush has even been urged to take the unprecedented step of nominating some of his successor's team. But Stephen Hess, at the Brookings Institution, gives warning that this could force Mr Obama to compromise with the outgoing administration on important decisions.

Even if the worst of the financial crisis has passed (a dangerous assumption), the worst for the economy is almost certainly ahead. After their near-death experience, bankers have turned exceedingly cautious. A Fed survey released this week shows them tightening lending standards to consumers by a greater margin than at any time in the survey's 40-year history, except for Mr Carter's short-lived imposition of credit controls. General Motors says that last month's car sales, relative to the population, have been the lowest since 1945.



How long, and deep, a recession?

The depth of the recession largely hinges on how long it takes for banks and private lenders to recover their appetite for risk. This, in turn depends on the course of home prices, loan losses and the ability of

financial firms to raise capital. Some officials at the Fed think that the recession could be as mild as it was in 1990-91. If so, it would probably be over around mid-2009 and unemployment will peak somewhere near 7%. In a more pessimistic scenario, the recession would rival that of 1981-82, lasting into late 2009 with unemployment reaching 8-9%.

The Fed has brought previous recessions to an end by pushing interest rates low enough for long enough. Its job this time is harder. Though its interest-rate target has dropped to 1%, the benefits have been blunted by bankers' and investors' lack of capital and by their suspicion of customers' creditworthiness. This has kept rates to corporate and household borrowers high. Corporate-bond yields are much higher now than 15 months ago when the Fed's target stood at 5.25%.

Historically, presidents have had little influence over short-term economic growth, and certainly less than the Fed's chairmen. But with monetary policy muffled, Mr Obama will bear more of the responsibility for fighting recession by way of fiscal policy. Congressional Democrats are already pressing for up to $150 billion in stimulus measures, such as aid to states and infrastructure spending. Mr Obama incorporated those goals in a two-year $175 billion proposal and may join forces with Congress to pass such a package in a "lame duck" session before inauguration day. Some advisers and outsiders want him to do even more. Economists at Goldman Sachs think that up to $500 billion in stimulus (3.5% of GDP) is necessary to offset the drop in private spending induced by tighter credit.

With stimulus of this magnitude, the costs of the bail-out and the recession's withering effect on tax revenue, the budget outlook is dreadful; next year's deficit could top $1 trillion. Given the alternative—an even worse recession—even deficit hawks will hush their protests.

But the president-elect has precious little breathing room. He faces momentous and unpleasant choices. One deadline is the expiration of Mr Bush's tax cuts at the end of 2010. Mr Obama had originally promised to extend them for all but the wealthiest 5% of households, whose higher taxes (along with a withdrawal of troops from Iraq) would finance tax credits and health-care subsidies to working-class families. The Tax Policy Centre, a research group, puts the cost of his health-care plan alone at $1.6 trillion over ten years. His more liberal supporters will expect him to keep those promises. But with a deficit threatening to exceed the post-war record of 6% of GDP (set in 1983), such largesse risks revolt by the financial markets, a point that Mr Obama's more conservative advisers will doubtless make.

In 1993 Mr Clinton, facing similar tension, ultimately sided with the deficit hardliners. If anything, the pressures on Mr Obama are even more acute. With baby-boomers about to retire in growing numbers, the cost of America's public-health and retirement programmes, if left unchanged, will rise from 8% of GDP now to 19% by 2050. Some economists dream that the time is ripe for a grand bargain that reforms the tax code, entitlements, and health care simultaneously, boosting productivity, raising revenue, expanding health-care coverage and putting the budget on the path to long-term balance.

Towards sterner regulation

Mr Obama also faces big decisions on reconfiguring America's system of financial regulation. The ad hoc takeovers, bail-outs and guarantees of recent months have vastly expanded the federal safety-net and increased potential taxpayer liability by trillions of dollars. The Fed and Treasury plan to wind down most of these programmes over the next two years, but it is tough to wean investors and banks from federal guarantees once granted. With six firms controlling three-quarters of America's $14 trillion in banking assets, "We have developed…a very serious too-big-to-fail problem," Ben Bernanke, the Fed's chairman, acknowledged last month.

Since none of these firms, or any financial company of systemic importance, can be allowed to fail, more intrusive supervision that limits risk-taking and thus profitability is inevitable. To replace the system of ad hoc rescues, Mr Obama's advisers may press for rapid action on a formal "resolution regime" enabling the federal government to take over and wind down firms. The bail-out law requires him to decide by May how to regulate derivatives and hedge funds. Eventually, he must also decide whether to merge or reassign the responsibilities of America's multiple federal and state regulators. The Fed has taken on extensive new powers in the past year—which may not be healthy either for the financial system or for the Fed, whose principal duties are to maintain stable prices and jobs. Mr Obama's views on such questions will influence who he appoints to fill the three vacancies on the Fed's seven-member board, and whether to reappoint Mr Bernanke whose term expires in 2010.

Economic problems abroad will also jostle for Mr Obama's attention. The financial crisis has destabilised

many emerging economies whose companies had participated in the credit boom. The International Monetary Fund’s $253 billion in resources could soon be critically stretched if other countries join Iceland, Hungary and Ukraine in seeking financial support.

The challenges facing Mr Obama are momentous; so is his potential. His solid mandate and strengthened majorities in Congress equip him with huge political capital. There is no shortage of problems demanding that he spends this capital.

The presidency

Signed, sealed, delivered

Nov 6th 2008 | WASHINGTON, DC
From The Economist print edition

Barack Obama owes his victory to blacks, Hispanics, the young, women of all races, the poor and the very rich

AP



IT WAS a suitably exhilarating end to the most thrilling presidential race in a generation. This was the longest election in American history, and the most expensive by far. It was also, on the Democratic side, the hardest-fought, with Hillary Clinton amassing almost as many primary votes as Barack Obama. But on November 4th the result was clear: Mr Obama beat John McCain by six points in the popular vote (52% to 46%) and 190 votes in the electoral college (364 votes to 174).

A sense of history in the making hung over the election: a country that has been torn apart by race peacefully elected a black man to the highest office in the land. Mr Obama's volunteers wore T-shirts inscribed with the slogan "Making history". People across the country cheered and wept when the result was announced. Both Mr Obama and Mr McCain gave speeches worthy of a turning point.

It was a turning point without any inconvenient drama. The stalemate in 2000 plunged America into two months of turmoil. Four years later the early exit polls suggested that John Kerry had won the election—and the final result did not emerge until 3am. The networks declared that Mr Obama had won at 11pm eastern time, as soon as the polls closed on the west coast, and Mr McCain made his concession speech shortly afterwards. But most people knew that Mr Obama had the election in the bag two hours earlier, when he won Ohio after easily holding on to Pennsylvania.

Mr Obama will enter the White House in January with a clear mandate to govern. He is the first Democrat since Jimmy Carter to win more than 50% of the vote (Mr Carter won 50.1%). He also has solid Democratic majorities in both the Senate and the House (see article). But the election was nevertheless a little short of the landslide that many Democrats had hoped for and even expected.

Mr McCain's 46% of the vote was surprisingly high given the headwinds that he had to contend with. The Democrats fell short of winning a 60-seat filibuster proof majority in the Senate. Mr Obama continued to do badly with the same white working-class voters that he had failed to connect with during the primary.

All change

Nevertheless, Mr Obama succeeded in unfreezing an electoral map that had been frozen for the past eight years. He won huge victories in Democratic strongholds in the north-east and on the west coast. He triumphed all over the industrial Midwest. He won two big prizes that eluded the Democrats in 2000 and 2004: Florida (by two points) and Ohio (by four). He expanded the Democratic imperium to include Colorado, New Mexico and Nevada. He also narrowly won Virginia, home to the capital of the old Confederacy, and a state that has not voted Democratic in a presidential election since 1964. He seems to have scraped a remarkable victory in North Carolina.

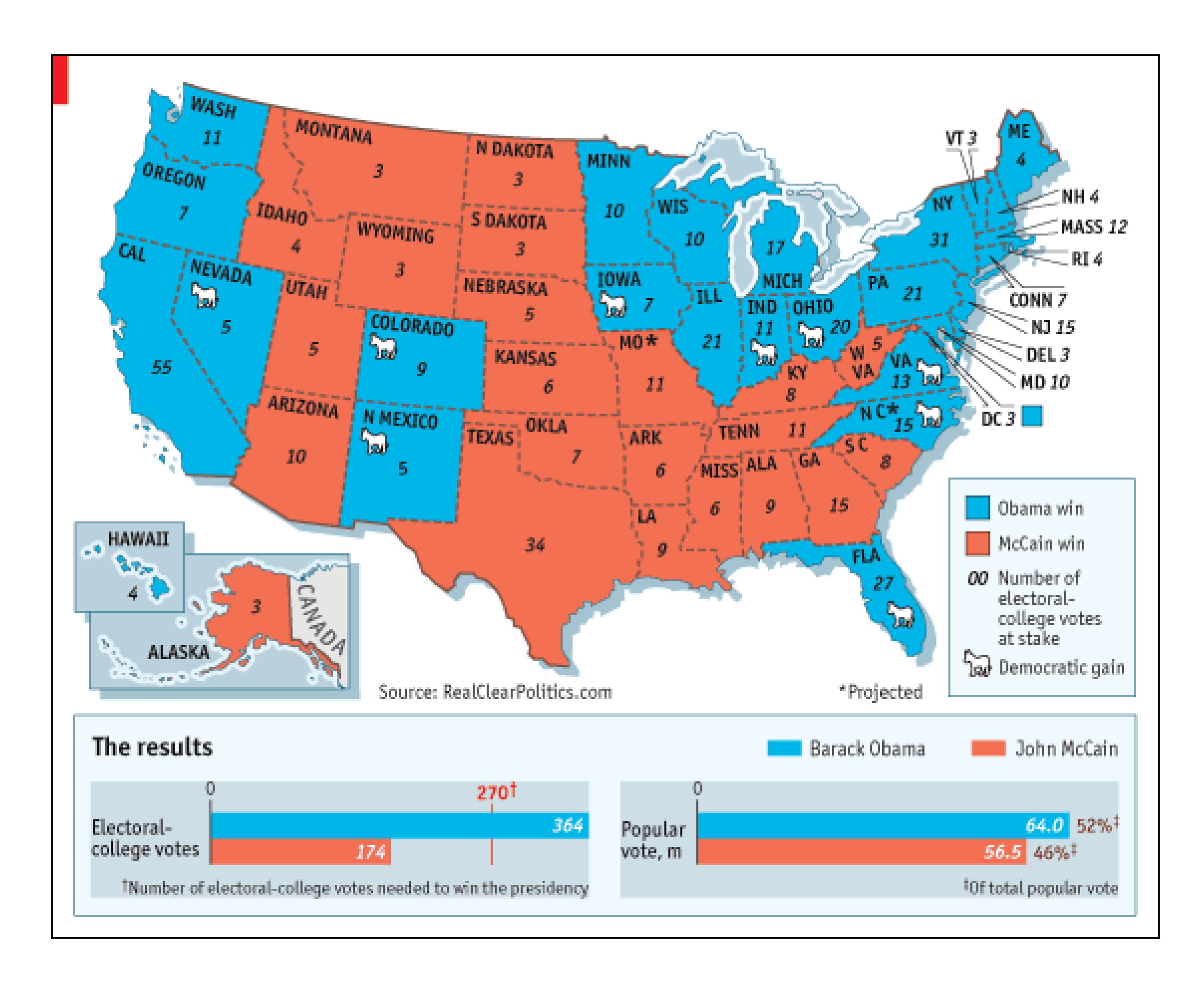
But Mr Obama did not really succeed in abolishing what David Axelrod, his chief strategist, calls the "dreary math of red state and blue state": the Republicans still dominate the South and the Great Plains. Mr Obama's 50-state strategy nevertheless paid rich dividends. It helped the Democrats win down-ticket races. It forced Mr McCain to devote his time and resources to defending what should have been solid Republican states, such as Georgia. On election day Mr Obama had many different paths to victory. Mr McCain had only one: he needed to hold almost all the states that George Bush won in 2004, and flip Pennsylvania to compensate for any losses. But Pennsylvania eventually voted for Mr Obama by 11 points.

In the same way Mr Obama succeeded in putting together an electoral coalition that was impressive without being revolutionary. Mr Obama's victory was largely a result of his huge margins among his core supporters—younger voters and minorities. He won 95% of the black vote compared with John Kerry's 88%. He won 66% of people aged 18-29 and 68% of first-time voters. But he did not break through to the "bitter" voters that have long troubled him. He lost whites without a college education by 18 points—only a small improvement on Mr Kerry's result—and voters aged 65 and over by eight points.

But there were nevertheless some significant trends beneath the surface of these predictable figures. Mr Obama won 66% of the Latino vote. He also won Latinos in Florida by an impressive 15 points, a group that voted Republican by 12 points just four years ago. George Bush was inordinately proud of winning 44% of Latinos in 2004. The Republican Party's nativist rejection of immigration reform has clearly cost it dear.

Mr Obama did well among the meritocracy. He did better than Mr Kerry among whites with a college education, a group that voted for Mr Bush in 2004, and which helped to carry him over the finish line in Virginia and Colorado, states with higher than average concentrations of the college-educated. He improved his party's performance among voters who earn more than $200,000 a year by 17 points.

Mr Obama's relentless courting of middle-of-the road voters also paid off, providing him with some evidence that he has succeeded in crossing the red-blue divide. He beat Mr McCain among independents (Mr McCain's supposed power-base) by eight points. Almost one in five voters who voted for Mr Bush four years ago shifted to Mr Obama. He won 54% of Catholics, a vital swing group in big industrial states such as Pennsylvania and Ohio. (Mr Kerry, himself a Catholic, won 47%.)



How did Mr Obama, a man who was a state senator just four years ago, pull off such a remarkable performance? The vote was as much a verdict on the past eight years of Republican rule, particularly the past four years of Mr Bush's presidency, with its cack-handed response to Hurricane Katrina, its mishandling of the war in Iraq and its exploding budget deficits. Throughout his campaign Mr McCain was haunted by two unavoidable numbers: three-quarters of Americans think that America is on the "wrong track" and two-thirds disapprove of Mr Bush's performance as president. Half of voters said that they believed that Mr McCain would continue Mr Bush's policies as president—and 90% of those voted for Mr Obama.

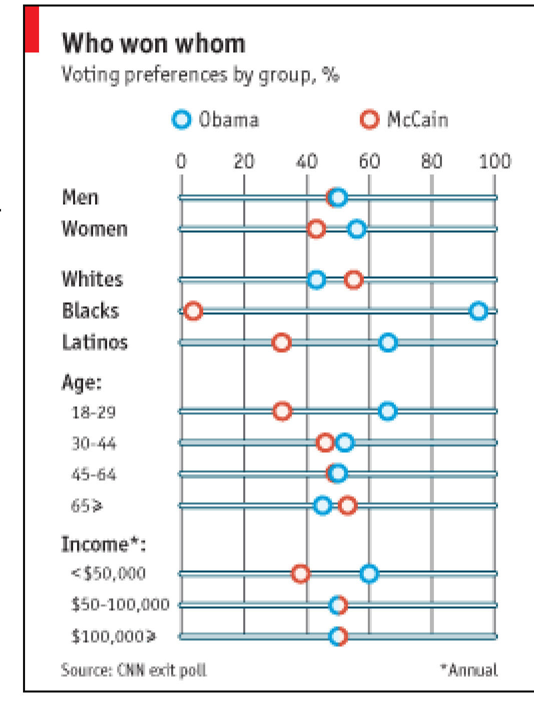
But Mr Obama exploited this disaffection like a master. He defeated the Clinton machine by understanding the magic of two words: "change" and "hope". And he turned an inchoate rage at Mr Bush's administration—a rage that had once threatened to drive the Democratic Party into undisciplined extremism—into the most effective machine seen in American politics for a very long time.

In both 2000 and (particularly) 2004 the Republicans won close elections by building a better political machine. This time the Democrats turned the tables. Mr Obama not only used his financial advantage to dominate the airwaves (he ran almost 140 ads a day in Pennsylvania in the week of October 21st-28th, for example). He also dominated on the ground, deploying armies of volunteers to knock on doors and drive people to the polls. In Ohio 53% of people told exit pollsters that they had been contacted personally by the Obama campaign, compared with 36% who heard from the McCain campaign.

But what finally persuaded a right-of-centre country to support a left-of-centre candidate was the economy in general, and the Wall Street meltdown in particular. Ninety-three per cent of voters said that the economy was in a bad way, and a full 81% worried about their financial future. Mr Obama led by nine points among the 63% of voters who said that the economy was their top concern. Worries about the economy allowed Mr Obama to shift attention from Mr McCain's strong suit, foreign policy, and shore up his support among sceptical blue-collar voters. "Forget drill, baby, drill," said Jennifer Granholm, the governor of Michigan. "Here, it's jobs, baby, jobs."

Arguably the moment when Mr Obama won the campaign was in mid-September, when the bankruptcy of Lehman Brothers triggered the worst financial crisis since the Depression. Undecided voters concluded that Mr Obama's calm and cerebral style was exactly what Americans needed in difficult times. And they worried about Mr McCain's temperament and judgment—

especially his insistence that “the fundamentals of our economy are strong.” From mid-September onwards Mr Obama enjoyed a lead in the polls that Mr McCain found impossible to break.



“Change” has rightly been the most popular word in this singular election season. The election changed the machinery of politics. The system of regulating campaign finance that was created after Watergate was shredded. The internet changed the way that politicians raise money and organise volunteers: YouTube, a ubiquitous force this year, did not even exist four years ago, and Facebook, which Mr Obama made enormous use of, had only been invented a few months earlier.

And the election has altered the election map: the Commonwealth of Virginia can now be added to the list of swing states, as can Indiana and North Carolina. The election also speeded up long-standing changes in the two parties: the Republican Party, having long ago shed its country club associations, is fast becoming much more of a Wal-Mart party. The Democrats are becoming the minority-meritocracy party, an alliance joining upscale whites with blacks and Hispanics of all income levels.

But for all the historical significance of Mr Obama’s victory it would be a mistake to over-interpret it: excited talk among liberals of the dawn of a new age of liberal activism is premature. The proportion of voters describing themselves as liberals, moderates and conservatives was almost the same as in 2004. The number of people who said that government should be more active was only slightly higher than four years ago—and fully 43% said that government was doing too much. In his admirable victory speech Mr Obama warned against hubris and promised to reach out to the people who did not vote for him. Heeding those calm words could be the key to a successful presidency.

A time to laugh...

Confetti and hot dates

Nov 6th 2008 | CHICAGO
From The Economist print edition

The Windy City celebrates its favourite son

“I HOPE confetti is still going to be poured on my head,” mused Surina Kumar, somewhere between the second and third security checkpoint at the rally for Barack Obama. “But how will they have confetti if we are outside?” More than 70,000 people were filing into Chicago’s Grant Park. For Miss Kumar and others, the question was not whether Mr Obama would win but what the party would be like.

Many supporters had spent the day outside the park, basking in the autumn sun, certain that their wait would be rewarded with Mr Obama’s triumph. Thousands had wanted to come but could not get in. Some ticket-holders had turned to Craigslist to seek love or money. Sale-899798993@craigslist.org displayed his obvious charms in search of a date: “I have no problem pulling hot girls in general so since I have Obama tickets you have to be not just hot but like supermodel hot.”

A few were more nervous. Cynthia Henderson stood waiting with her teenage daughter. Ms Henderson, who is black, grew up on Chicago’s West Side; neither of her parents finished college. She is now a doctor. “What do we want for our kids?” she asked. “We always want them to be able to do better.” Mr Obama, she thinks, can help.

As the result became clearer, supporters were more and more excited, hooting at the returns and electrified by their role in this historic moment. At 10pm, when CNN called the election for Mr Obama, there was an ecstatic eruption. In one corner of the giant field Ms Henderson wept silently in her daughter’s arms. When she finally disengaged, her first word was: “Sublime”.

Mr Obama appeared, his words echoing off the city’s historic façades, which had seen riots 40 years earlier. The crowd listened in happy reverence, then flooded Chicago’s streets, unleashing their exuberance in hoots and hollers, sure that the country would change for the better.

...and a time to weep

Scenes from a wake

Nov 6th 2008 | PHOENIX
From The Economist print edition

The defeated candidate outclassed his supporters

JOHN MCCAIN's presidential ambitions ended in Phoenix's swankiest hotel. Next to a ballroom packed with Republican donors and activists, Wright's restaurant served up lashings of arugula. The hotel's spa offered caviar facials and champagne pedicures. After weeks of populist talk about Joe the Plumber and hockey moms, the splash of luxury was rather refreshing.

The evening began well. An affluent crowd, done up to the nines, waved their pom-poms and cheered every announcement of Republican triumph, no matter how predictable ("Hey! We've won Utah!"). They jeered as a rock band sarcastically honoured Barack Obama with songs like "Nowhere Man". Many knew the election was lost, and reckoned they might as well enjoy the party.

As the scale of the rout became clear, though, the mood turned glum. "Every civilisation comes to an end eventually," declared one participant. Many had cross words for reporters, who are broadly believed to have given Mr Obama an easy ride. A woman tried (jokingly?) to throttle your correspondent.

Shortly after eight o'clock, the crowd was told to go outside to await an announcement from Mr McCain. There they stood, stiletto heels sinking into the lawn, and were treated to an eloquent, gracious speech. The defeated candidate wished Mr Obama well and explained he was proud that America had elected a black man. He even expressed sadness that Mr Obama's grandmother did not live to see his victory.

The crowd's response was not nearly so gracious. It loudly booed when Mr McCain mentioned Mr Obama and Joe Biden. When the Arizona senator urged supporters to join him in helping the new president, there were cries of "No!" and "Bush-basher!" Perhaps most worrying, the crowd seemed keener on Sarah Palin than on their own senator.

Much earlier than many had expected, people spilled out to retrieve their cars from the valet. Driving away from the Biltmore, the aura of luxury faded quickly. Phoenix has America's sixth-highest foreclosure rate, and the city's finances are a mess. A mile from the hotel, streets were filled with abandoned houses and auction notices—signs of the crisis that, more than anything else (and certainly more than the wicked media) doomed Mr McCain to defeat.

Congress

Happy days for Democrats

Nov 6th 2008 | CHARLOTTESVILLE
From The Economist print edition

Republicans suffer their second crushing defeat in two years

IN A Republican campaign office in Charlottesville, Virginia, the signs on the walls captured the mood. “The presidency is no place for on-the-job training,” said one, quoting Joe Biden’s put-down of Barack Obama during the Democratic primaries. Another notice complained that Mr Obama’s supporters had stolen someone’s McCain-Palin yard sign, thus violating his First Amendment right to free speech. “Try it again and you will risk finding out what the Second Amendment is all about,” it warned. (The Second Amendment is the one about guns.)

Suzanna Turanyi walked in out of the rain. A newly-minted American citizen, she had just voted for the first time. Her friend Rachel Schoenewald, a Republican volunteer, urged everyone in the room to applaud this happy news. They did so with enthusiasm. When asked, however, Ms Turanyi was a trifle embarrassed to admit that she had voted Democratic.

Senate seats

2 Democrats
2 Republicans
1 Republican 1 Democrat
Result pending
Democratic gain

Current standing

	Democrat	Republican
2008 result	17	14
No election	*39**	*26*
TOTAL	56	40

*Includes 2 independents, one each in Connecticut and Vermont

Source: CNN

Ms Turanyi, who works for an internet firm, says she could have voted either way. But she backed Mr Obama because she does not like George Bush “at all” and she thinks the past eight years have been grim. She voted for Democrats further down the ticket, too. For the Senate, she backed Mark Warner, a mobile-telephone tycoon once tipped as a presidential contender. For the House of Representatives, she backed Tom Perriello, a fresh-faced novice seeking to unseat Virgil Goode, an ornery six-term social conservative who says harsh things about illegal immigrants.

Voters like Ms Turanyi handed Republicans their second thumping in as many years. In the House, Democrats increased their majority from a comfortable 36 seats (with one vacancy) to a commanding 81 seats, with eight still to be decided. In the Senate, they picked up at least five seats, turning a slender 51-49 majority into a comfortable one. But they seemed unlikely to reach the 60 seats needed to prevent Republicans from blocking bills.

Blue regions turned bluer. The last House Republican in New England, the moderate Chris Shays, was sent packing. New York City’s House delegation is now all-Democratic. And parts of the country Republicans once took for granted decided it was time for a change.

Virginia is a case in point. Two years ago both its senators were Republican. Now the state will have two Democrats. In 2006, Jim Webb, a former navy secretary, inched past George Allen, the tobacco-chewing Republican incumbent. This week, Mr Warner thrashed the Republican Jim Gilmore by an incredible 64% to 34%. Both men were former governors, but Mr Warner was much more popular. On the night before the election, he gave a speech to a crowd of 80,000 that lasted barely a minute. He did not need to say much. He was introducing Mr Obama. The sight of him holding hands with the hope-monger was enough to sway doubters, not that there were many.

House races in Virginia went well for Democrats, too. The party picked up an empty seat and ousted Thelma Drake, a one-time single mother and property investor. The race between the Republican Mr Goode and the Democrat Mr Perriello, meanwhile, was practically a dead-heat. Only a couple of hundred votes, out of 300,000 cast, separated the two men.

It would be a mighty upset if Mr Goode loses. He won by 28 points in 2004 and 19 in 2006. But he was caught in an anti-Republican tornado. Rural people in his district may share Mr Goode's love of God and guns, but they don't love the looming recession, for which many blame Mr Bush. And liberals in college towns such as Charlottesville think Mr Goode is a bigot: he said some spiteful things when the first Muslim congressman wanted to swear his oath of office on the Koran last year.

Steady gains

House of Representatives, seats*

2008

Democrat gain 19

Undecided* 8

2008

Democrat hold 235

Republican hold 173

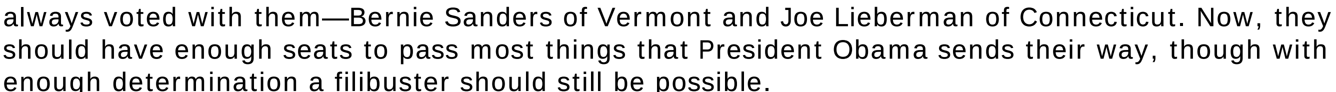
Total number of seats–435

Source: RealClearPolitics.com

*At time of publication

Breaking the Republicans' hold

The Senate is transformed. For the past two years, Democrats have had the smallest possible majority, with 51 seats out of 100, and even that depended on two independents who usually but not always voted with them—Bernie Sanders of Vermont and Joe Lieberman of Connecticut. Now, they should have enough seats to pass most things that President Obama sends their way, though with enough determination a filibuster should still be possible.



The Republicans are reeling. The Senate minority leader, Mitch McConnell of Kentucky, clung to his seat with a much reduced margin, but other heavyweights were not so lucky. In North Carolina, Elizabeth Dole, a former head of the American Red Cross and the wife of one-time presidential nominee Bob Dole, suffered a heavy defeat. Her Democratic opponent, a little-known state senator named Kay Hagan, put out an ad that slyly drew attention to her age.

Two old coots sit in rocking-chairs. "I'm telling you, Liddy Dole is 93," says one. In fact, Mrs Dole is 72, but the coot explains that some watchdog organisation once ranked her the 93rd most effective senator. The other coot replies that Mrs Dole is 92—as in, she voted with George Bush 92% of the time. Mrs Dole insisted that the true figure was 55%. But neither that, nor a bizarre ad trying to link Mrs Hagan, a former Sunday-school teacher, with militant atheists, was enough to save her.

In Colorado and New Mexico, Democrats Mark and Tom Udall, who are cousins and keen environmentalists, each captured an empty Senate seat left vacant by a retiring Republican. In New Hampshire, John Sununu, a moderate Republican, was drubbed by Jeanne Shaheen, a former governor. During the campaign, like most Democrats, Mrs Shaheen relentlessly repeated that her opponent was just like Mr Bush. It was not true, but it worked.

No Democratic incumbent lost a Senate seat but, as *The Economist* went to press, four races involving Republican incumbents were still undecided. In Minnesota, the moderate Norm Coleman was ahead of Al Franken, a smutty comedian with a serious side, by about 470 votes out of nearly 3m cast, a margin so slim it will trigger an automatic recount which could take several weeks. Saxby Chambliss, a conservative Georgian, appeared to be heading for a December run-off, thanks to the state's rules and the presence of a libertarian candidate. In Oregon, Gordon Smith, a centrist who is distantly related to the Udalls, though on the other side of the aisle, was slightly behind. Slightly ahead, incredibly, was Ted Stevens, a pork-spreading Alaska Republican convicted last week of concealing gifts from contractors.

AP

In the House, only four Democrats lost. All were newcomers, elected in conservative districts as part of the last Democratic landslide in 2006, and one had been involved in a sex scandal. Jack Murtha, who denounced his own constituents as racists shortly before they elected Mr Obama, survived a challenge in Pennsylvania. But he has already held his district for 17 terms, and delivered plenty of pork.

The Republicans, meanwhile, were decimated, losing at least 19 of their 199 House seats. Congressional Republicans promised to work with the new administration, but their caucus is smaller, more conservative and grumpier than before. A cull of its leaders is likely. Adam Putnam, the number-three Republican in the House, has already resigned his post.

The Democrats may also lose talent, but for happier reasons. Rahm Emanuel, the number-four Democrat in the House, looks set to become Mr Obama's chief of staff. That would be a good pick. Mr Emanuel, a former ballet dancer who swears a lot, is both clever and pragmatic. But

he will have a tough job restraining his former colleagues. Nancy Pelosi, the House speaker, promised that congressional Democrats would govern from the centre. But their majorities may mean they don't have to.



Bye bye Liddy

Gubernatorial races

No time for a novice

Nov 6th 2008 | CHICAGO
From The Economist print edition

Eight governors are re-elected

THIS year may have been about “change”, but at state level the dynamic was rather different. On November 4th Democrats held 28 governors’ mansions and Republicans 22. The next day only one state had moved to the Democrats’ column. Most voters opted for stability.

Of the 11 races this year, seven were virtual shoo-ins for incumbents. On the Republican side, some governors kept their posts by being economic contrarians. While the rest of the country suffers, in North Dakota John Hoeven has overseen an energy boom and diversified the local economy. He became North Dakota’s first governor to win three four-year terms. In Utah Jon Huntsman’s record of surpluses secured him 78% of the vote. Indiana’s Mitch Daniels, who has helped keep his state’s unemployment rate lower than its neighbours’, flicked away his challenger. Even Jim Douglas, a Republican and fiscal conservative in lefty Vermont, was able to fend off his Democratic opponent.

Three incumbent Democrats showed a firm grip as well. Montana’s superbly loquacious Brian Schweitzer touted low taxes and a growing energy sector: “the showhorse” trotted briskly over his opponent. West Virginia’s Joe Manchin, who has lowered taxes and helped pay unfunded liabilities, won by more than 40 points. New Hampshire’s John Lynch preached a record of fiscal prudence to an acquiescent choir. And in Delaware one term-limited Democrat was succeeded by another, Jack Markell, who won 68% of the vote.

The only major upset was in Missouri, where Matt Blunt, the Republican governor, did not seek re-election. Kenny Hulshof, a Republican congressman, tried to succeed Mr Blunt, whose unpopularity was matched only by that of the Belgian brewers who bought Anheuser-Busch this year. But Mr Hulshof struggled through the primary, then wilted beside the sturdy campaign of Jay Nixon, the attorney-general. The Democrat won by 18 points.

The closest races were in North Carolina and in Washington. In North Carolina Beverly Perdue, the lieutenant governor, and Pat McCrory, the Republican mayor of Charlotte, battled to succeed the term-limited Democratic governor. Mr McCrory had tried to capitalise on Mr Obama’s message of change, but it was the Obama campaign’s surge of new voters that seemed to have the greatest effect. Ms Perdue will be North Carolina’s first female governor.

The nastiest fight was in Washington. In 2004 Christine Gregoire, a Democrat, defeated Dino Rossi by just 133 votes. Mr Rossi did not concede the battle until June 2005. This election was an ugly reprise. Democrats filed a lawsuit to force Mr Rossi to list himself on the ballot as a Republican rather than as “GOP”. On October 29th Mr Rossi gave a deposition about allegedly illegal fund-raising by a construction lobby. In the end, Ms Gregoire looked set to win.

These governors now have the unenviable task of governing. Falling oil prices may hurt North Dakota and Montana. Missouri’s unemployment rate is at its highest level since 1991. Utah, once an oasis of fiscal stability, now has a mid-year budget gap of $354m. In Washington, state revenues for July-September, after adjusting for inflation, were 10% lower than they were during the same period last year, according to the Centre on Budget and Policy Priorities. Most states cannot run a deficit even in a downturn, but must raise taxes, cut spending or dig into reserves. The campaigns are over. Now for the hard part.

The Republicans

Palin for 2012!

Nov 6th 2008 | WASHINGTON, DC
From The Economist print edition

The next election is already under way

IT'S never too early to start planning for the next election, and across America the sharpest political minds are already considering how best to take on Barack Obama. One thing is certain: there will be no shortage of volunteers for the position of Republican nominee in 2012.

The most visible of the probable contenders is Sarah Palin. Barely two months ago, she was virtually unknown outside Alaska. Now she has supplanted Hillary Clinton as the most divisive woman in American politics. Democrats advertise their contempt for her with "Mooselini" T-shirts and "Bro's before Ho's" badges. Feminists revile her in language they would hesitate to use about a man.

Yet to her fans, she has it all: youth, faith, a lovely family and star power on the stump. She may have fluffed basic questions about national politics, but she is a quick student. Her recent speech on energy was quite substantive. Cultural conservatives warm to her. "Everything about her is likeable," says Sandra Montjoy, an admirer at a rally in Virginia. Her doomed run for vice-president has allowed her to make contact with more voters like Mrs Montjoy than any of her likely rivals. And America has still not had a female president.

Republicans would love to notch up an historic first, and America is surely ready for a woman in the White House. But as Mrs Clinton discovered, it is hard to get there if half the country dislikes you before you begin.

If Mrs Palin stumbles, plenty of others are poised to pounce. Some of those who lost in the Republican primaries are itching for another try. Mike Huckabee, a former governor of Arkansas, combines Mrs Palin's small-town Christian appeal with an arsenal of self-deprecating jokes and impressive verbal dexterity. Few interviewers can outsmart him. And since he now has his own show on the Fox News channel, he can charm conservatives at his leisure.

Mitt Romney, another ex-governor, has been diligently stumping and raising money for John McCain and other Republicans. If the economy fails to revive, the party might want a financial whizz to top the ticket. (Mr Romney made a fortune in venture capital.) But he failed to connect with ordinary voters this year, and it is hard to see that changing in 2012.

None of the Republicans in Congress looks electable nationally, so the party will probably be looking for a governor. Fiscal conservatives admire Mark Sanford of South Carolina. Blue-collar populists prefer Tim Pawlenty of Minnesota. Charlie Crist of Florida has his fans. Some Republicans, however, think the best way to change the party's battered image would be to pick Governor Bobby Jindal of Louisiana. Like Mr Obama, he is young, thoughtful and articulate. Unlike Mr Obama, he has also run a state. And what better way to squash the charge that Republicans represent only whites than to nominate an Indian-American?

Ballot initiatives

Dispatches from the culture wars

Nov 6th 2008 | PHOENIX
From The Economist print edition

Bad news for gays, good news for stoners

FOR a sense of the cultural landscape that Barack Obama will inherit, look to the results of state ballot initiatives. Although often regarded as little more than a sideshow, they provide the best clues to where Americans stand on hot-button social issues. Some initiatives provoked enormous passions and donations. California’s Proposition 8, which defines marriage as a union between a man and a woman, attracted more money than any other campaign in the nation except the presidential one.

Selected state referendum results, %

State	Issue	Yes	No
Arkansas	Prevent unmarried couples, gay or straight, from adopting	57	43
California	End same-sex marriage	52	48
Colorado	Confer personhood on fertilised eggs	27	73
	Ban racial preferences in public employment and contracting	50	50
Florida	Prevent same-sex marriage	62	38
Massachusetts	Decriminalise small-scale marijuana use	65	35
	Abolish state income tax	30	70
South Dakota	Criminalise abortion, with exceptions for rape and maternal health	45	55
Washington	Allow terminally-ill adults to request and take a lethal mix of drugs	58	42

Sources: CNN; *The Boston Globe*

That measure passed by the margin of 52% to 48%. Despite advertisements featuring Hollywood tough-guy Samuel L. Jackson, the backing of Governor Arnold Schwarzenegger and a late surge of donations, opponents of the measure could not overcome a broad-based, passionate campaign in support. The victory, coupled with success for similar measures in Arizona and Florida, is a huge setback for the gay-rights movement. But it is good news for lawyers. Some 22,000 couples, many from out of state, have tied the knot in California since same-sex marriages became legal in June. It is by no means clear that they can be retroactively stripped of their status. The courts will be busy for years.

Elsewhere the news was better for liberals. Voters in South Dakota struck down an attempt to ban nearly all abortions. If the effort had prevailed, it would have given the Supreme Court a chance to revisit *Roe v Wade*. The residents of Colorado crushed a crude attempt to abolish abortion and stem-cell research by defining human eggs as people from the moment of fertilisation. Californians struck down a measure that would have forced doctors to inform parents that their teenage daughters were seeking abortions. Washington became the second state, after Oregon, to legalise assisted suicide. Terminally-ill adults will be able to ask doctors to prescribe them a lethal cocktail of drugs, although they will have to take the drugs themselves.

Meanwhile stoners continued their slow, shuffling march to social acceptance. Massachusetts voters decided to downgrade possession of less than an ounce of cannabis to an infraction, punishable by a mere $100 fine. Michigan legalised medicinal marijuana.

Many of the less closely-watched contests hinted at a more conservative mood, however. The people of Colorado struck down two attempts to raise taxes. Californians made it easier to deny parole to violent criminals and opted not to offer drug treatment to many non-violent offenders. Arizonans saw off an attempt to water down laws punishing businessmen for employing illegal immigrants.

There is a lesson in all this for the next president. America remains a largely conservative country, opposed to gay marriage, worried about crime and suspicious of tax rises. For all the talk of making

history, Mr Obama will preside over a nation that remains substantially to his right on many social and economic issues. He must work out how to meet people half-way.

State legislatures

Down at the bottom

Nov 6th 2008 | WASHINGTON, DC
From The Economist print edition

Democrats gain all round

HOW deep was the Democrats' victory? From the top of the ticket to the bottom, the party netted seats—including in state legislatures, those "incubators of democracy" that set much of America's public policy, redraw federal legislative districts and train future congressmen, senators and presidents. Indeed, half the members of the current Congress served in a state legislature—and, as the National Conference of State Legislatures (NCSL) points out, soon 100% of the White House will be held by a man who was still in the Illinois Senate only four years ago.

Eighty per cent of the country's 7,382 state legislative seats were up for grabs on November 4th. The Democrats held a big advantage in the legislatures, controlling 23 to the Republicans' 14. Twelve were split, with one house each for the big parties and one—Nebraska's—is non-partisan. On election day, the Democrats increased the number of state capitols in their hands by four. After new lawmakers are sworn in, the Republicans will still control 14, while eight will be split.

The NCSL's Tim Storey estimates that Democrats added only about 1% of seats to their column. Still, that won some big prizes. They took the New York Senate, controlled by Republicans since 1966. The governor and the state Assembly both favour legalising gay marriage. A Democratic Senate might, too. The Democrats trounced their opponents in Delaware, taking the state House. Now the party controls every eastern state legislative chamber north of Virginia, save for the Pennsylvania Senate. The party that wins the White House usually wins seats, and Mr Obama's operation probably helped the Democrats in swing states like Wisconsin, Nevada and Ohio, where they also wrested control of legislative chambers.

As blue states got bluer, red states got redder. The Republicans made up for their losses up north with victories in Tennessee and Oklahoma. Neither has ever had a Republican legislature. There haven't been this few divided legislatures since 1982.

Republicans might also take heart from the fact that there will be more elections between now and the time when legislators will draw up new boundaries for congressional districts. And many incoming state lawmakers may be hurt by huge budget problems. But the Democrats now have a lot of incumbents, and some will no doubt be hard to dislodge.

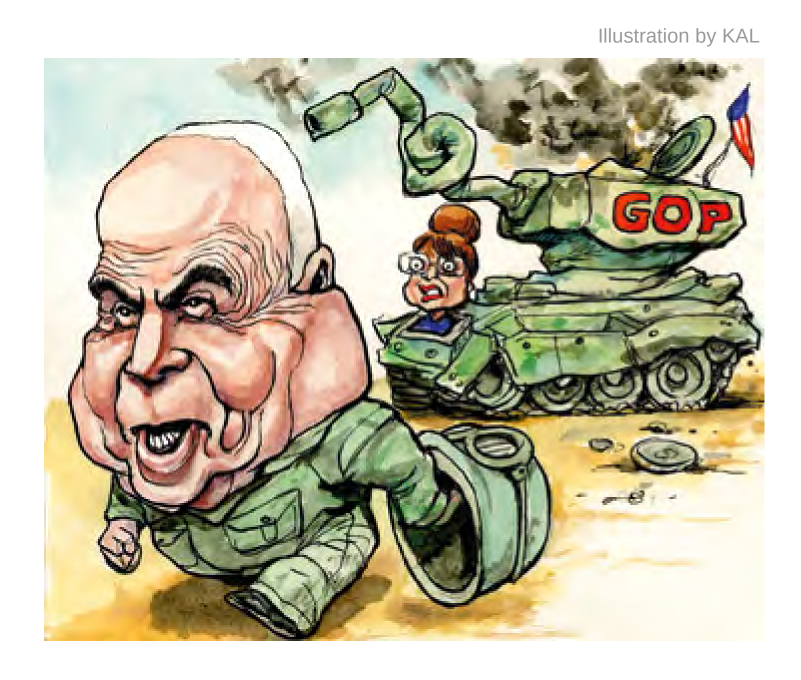
Lexington

The unhappy warrior

Nov 6th 2008
From The Economist print edition

Fate dealt John McCain an impossible hand

Illustration by KAL



NOTHING became John McCain's campaign like the ending of it. In a graceful and even moving concession speech on election night, he urged all Republicans to put aside their partisan differences and support Barack Obama as he grapples with the many challenges facing America. His audience was less than equally gracious; but that is hardly his fault.

There have been a few reminders in the closing stages of his doomed campaign of why Americans once fell in love with the guy. Another was his appearance on "Saturday Night Live" on November 1st. Standing next to Tina Fey—the woman whose impersonation of Sarah Palin has done more than anything to turn his campaign into a punchline—Mr McCain made light of his predicament. He could not afford half-an-hour of airtime on the major channels, like his rival, he claimed; so he was appearing on the shopping channel, making his case as best he could while also trying to "sell you some stuff", such as a limited edition of "Joe action figures"—Joe the Plumber, Joe Sixpack and Joe Biden (pull the cord and he talks for 45 minutes). He also brought the house down at the Al Smith memorial dinner on October 16th.

But for the most part America has been confronted with a very different McCain from the man who ran against the Bush machine in 2000—a party loyalist who preaches the old-time true religion (particularly on tax cuts and oil-drilling) and who is happy to link arms with the people who destroyed him eight years ago. Why this bizarre *volte-face*? Mr McCain's strength in an anti-Republican year lay precisely in the fact that he is not a blood-and-thunder Republican. The McCain of 2000 rejected the strident moralism of the religious right in favour of a more tolerant conservatism, and broke with the my-way-or-the-highway politics of the Republican establishment in favour of bipartisanship. If anybody could hold on to the White House against a Democratic hurricane, it was surely that Mr McCain.

The state of the economy was surely Mr McCain's biggest problem, but he was also doomed by two other factors. The first was the impossibility of appealing to both Republican activists and independent voters. Mr McCain needed both groups to win: the activists because they do the hard work in elections and the independents because self-identified Democrats outnumber self-identified Republicans by about ten points. But, as a Democracy Corps poll revealed last month, today's Republican activists live in a different mental world from the rest of the electorate: a world in which Mrs Palin was a good choice, in which their candidate has been too mealy-mouthed in making his case, and in which the Republican Party needs to

move to the right to win elections.

The second was media bias. A survey for the Pew Centre's Project for Excellence in Journalism found that, in the six weeks between the conventions and the last debate, unfavourable stories about Mr McCain outnumbered favourable ones by more than three to one. When Mr McCain tried to focus on "non-Republican" issues such as poverty, the media all but ignored him; when Mr Obama broke his pledge to restrict himself to public financing, the media tut-tutted at first, but quickly moved on. One need only imagine how the *New York Times* would have reacted if a Republican candidate had broken such a pledge, and then gone on to amass a war chest of $639m to his opponent's $360m, to see how profound the bias has been.

But all this brought out some deep-rooted weaknesses in Mr McCain's character, too. The self-styled maverick undoubtedly has great strengths—he's the most entertaining dinner companion in Washington and one of the most natural campaigners in any party. But those strengths go along with equally large weaknesses. He's a temperamental cove who wears his heart on his sleeve. He's also a seat-of-the-pants politician with little tolerance for tedium. Mr McCain allowed his dislike of Mr Obama to show through. He may well be right to think that the Wunderkind had broken his word not just on public campaign finance but also on several other issues, including holding a series of "town-hall" debates. But his angry performance in the third debate looked disrespectful, if not actually a little unhinged.

Mr McCain also paid the price for his aversion to dull slog. He contracted out the hard work of organising his campaign to apparatchiks such as Steve Schmidt, a protégé of Karl Rove. But these apparatchiks seemed more interested in winning the daily news cycle than in sticking to an enduring argument. He also failed to do his homework on the Wall Street meltdown—barrelling into Washington for a White House economic summit and then discovering that he had nothing to say. Being a maverick, it seems, is a useful qualification for a senator, but not for someone who aspires to hold the most powerful and difficult job in the world.

The pain of Palin

Mr McCain's various problems, temperamental and circumstantial, found their perfect expression in the worst single decision of the 2008 election season—his choice of Mrs Palin as his running-mate. Mr McCain had hardly met her when he made his fateful decision (he reportedly wanted a centrist such as Joe Lieberman or Michael Bloomberg, but his advisers talked him out of it). Mrs Palin was supposed to help him thread the electoral needle—revving up the base while the maverick-in-chief reached out to independents. Instead she heightened the contradictions of the Republican coalition, bringing out the worst in her party and scaring the pants off swing voters.

In the end, there is something tragic about Mr McCain's fate. The only time when he could display his qualities to the full was when fighting a losing battle against the mighty Bush machine in 2000. And the only time he could seize control of his party was when it was facing the longest odds it had faced since Watergate: torn apart by internal tensions and loathed by most of the electorate. A pity: there are few better men in American politics.

Brazil

The credit crunch reaches Brazil Inc

Nov 6th 2008 | SÃO PAULO
From The Economist print edition

A big bank merger points to a tougher outlook for the private sector, but at least this time the public finances are not the problem

Reuters



JUST a few months ago, Brazil's economy was growing at its fastest pace since the mid-1990s, driven by record commodity prices and record credit growth. The country's president, Luiz Inácio Lula da Silva, declared confidently that "Bush's crisis" in the United States would not affect Brazil. It all looks very different now. Credit is becoming scarcer and banks more suspicious of each other.

Two of the largest, Itaú and Unibanco, announced a merger on November 3rd, creating a bank with combined assets of 575 billion reais ($263 billion). This will be the biggest bank in Latin America, the sixth-largest in the Americas and in the world's top 20. The news pleased the merging banks' shareholders but did not divert anyone else from the general gloom. In the free-trade zone around Manaus, in the Amazon, a dozen companies have told their staff to take unpaid leave, the first time this has happened in three decades.

The problems began suddenly, with a sell-off last month of Brazilian shares and the currency as foreign investors rushed to cover losses elsewhere, or just went home. The sell-off triggered unexpected losses on foreign-exchange derivatives that were meant to limit the exposure of Brazilian companies to currency moves but have exacerbated it instead. "While the real was appreciating these contracts looked like a fairly safe one-way bet," says Marcelo Carvalho of Morgan Stanley. "Companies got Lula-ed into a false sense of security."

The Brazilian press estimates that some 200 companies hold such contracts. For many, these instruments at best were peripheral to their business. Some have already acknowledged big losses. Jitters over how many more will follow, and confusion over how these contracts will be enforced in the clogged courts, has spread fear and caused banks to retract lending.

To make matters worse, external funding has dried up. Figures from the central bank show that credit lines to finance trade, normally considered low-risk, are running at about half the level of mid-September. There are reports that farmers are finding it hard to find credit to buy fertilisers and pesticides, which could affect next year's harvest. Furthermore, consumer credit is becoming scarcer as banks anticipate a rise in bad loans. The monthly payments demanded for everything from cars to football boots are rising.

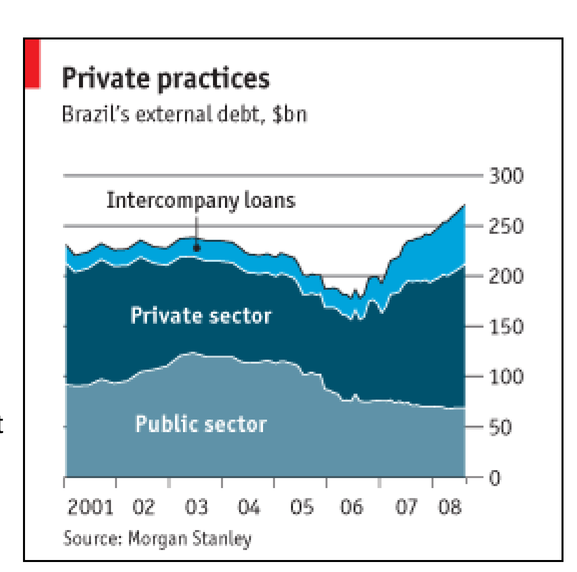
The government is no longer saying that Brazil will be untouched by the rich world's recession. On October 30th Paulo Bernardo, the planning minister, confirmed that the government has reduced its target for the primary fiscal surplus (the difference between revenue and spending before debt payments) for 2009 from 4.3% to 3.8% of GDP. He said this was in order to maintain spending on infrastructure projects. But the change is unlikely to be sufficient for this purpose, particularly given that many of the government's plans depend on private investors being able to raise credit.

The Central Bank has put measures in place to make sure that those who need access to dollars can get them, while quietly indicating that it has enough dollars to prevent sudden moves in the value of the real. On October 29th the United States Federal Reserve announced a deal with Brazil, Singapore, South Korea and Mexico under which it will provide up to $30 billion to each of them. These steps seemed to bring some stability to the exchange rate.

Officials have also moved to shore up the banking system. The government has reserved the right to take stakes in struggling banks, via two big state-owned ones, Banco do Brasil and Caixa Econômica Federal. Banco do Brasil is negotiating to buy several smaller banks owned by state governments. Itaú's merger with Unibanco will probably trigger a new round of consolidation among private banks. Itaú, which will have a majority stake in the new bank, began to talk to Unibanco last year, when Spain's Banco Santander bought Banco Real from ABN AMBRO, a Dutch bank, turning it into Brazil's third-largest private lender. The financial turmoil "accelerated" the talks, according to Roberto Setúbal, Itaú's chief executive, who will hold the same post in the merged bank. The deal may prompt acquisitions by Bradesco, previously the market leader.

Although credit has been growing fast, it still amounts to only about 40% of GDP—a much lower figure than in developed economies. That is partly because reserve requirements and interest rates are the highest in the world. Because of past financial crises, most banks are conservatively run. "Brazil's economy has been travelling with the brakes on," says Eduardo Giannetti of IBMEC, a business school. "At times like this that can be an advantage." Big bank failures seem unlikely at the moment.

The government has used the favourable conditions of the last few years to improve its finances. The public sector's debt has fallen to less than 40% of GDP, down from over 60% in 2002. At the same time, the government has retired most of its dollar-denominated debt. This means that at least currency depreciation does not trigger fiscal problems.



But companies took advantage of Brazil's new-found financial stability to raise dollar loans and issue bonds abroad, and to load up on derivatives (see chart). The result is a novelty for Brazil: a financial problem made entirely in the private rather than the public sector. That is progress of a sort. But it means that investment will slump. Analysts have slashed their forecast for growth next year to between 2% and 3%. Even so, many other big economies will fare worse.

Bolivia and the United States

Non grata

Nov 6th 2008 | LA PAZ
From The Economist print edition

A tit-for-tat tiff

Reuters



Morales takes on the empire

IT BEGAN in June, when coca growers in the Chapare region of Bolivia threatened to ransack the local offices of the United States Agency for International Development (USAID), which has worked on anti-drug efforts there for the past 25 years. After the aid workers' hurried departure the American ambassador, Philip Goldberg, was the next to go, expelled by Bolivia's socialist president, Evo Morales. On November 1st it was the turn of the agents of the Drug Enforcement Administration. Like Mr Goldberg, they were accused of conspiring with the opposition to overthrow Mr Morales, and were sent packing.

What was surprising about all this was that it has only happened more than two years after Mr Morales took office. A coca-workers' leader before he was elected president, he has spent much of his adult life battling against America's "war on drugs" in Bolivia. He talks the far-left language of ending dependence on the American "empire", the IMF, the World Bank and the like.

But Mr Morales has a pragmatic streak, too. He knows that at least 30,000 jobs in Bolivia depend on duty-free exports to the United States. Many of them are in the textile factories and workshops of El Alto, a satellite city of La Paz and one of his political strongholds.

George Bush's administration responded to Mr Goldberg's expulsion by declaring Bolivia unco-operative on drugs. It also plans to suspend tariff preferences for Bolivia's imports. The government points out that it is wiping out more than 5,000 hectares (12,000 acres) of coca this year (though the UN reckons Bolivia's cocaine output rose 11% in 2007).

It says that Venezuela and other new allies will take the goods Bolivia was exporting to the United States. That looks unlikely. Mr Morales, the first Andean Indian to be elected president in Bolivia, is popular; he won a recall referendum in August with 67% of the vote. But plunging commodity prices will hit the economy. Bolivia can ill afford to lose the American market for its manufactures.

Mr Goldberg's offence was merely to have met opposition governors. But he did so at a delicate time, when the opposition was staging violent protests in the aftermath of the referendum. Since then, the government and the opposition have agreed changes to a controversial new constitution that has divided them for a year. That document will go to a referendum in January. Assuming it is approved, Mr Morales will seek a second term at an election next year. Secure in the short term, but facing a deteriorating economic outlook, he might be wise to seek a rapprochement with the "empire". Now that it has chosen a new president he could even do so with little loss of face.

Religion in Latin America

Hola, Luther

Nov 6th 2008
From The Economist print edition

A holiday that is a cultural milestone

LATIN AMERICAN countries have long celebrated a plethora of Roman Catholic public holidays, from Corpus Christi to St Peter and St Paul. But this year Chile set a regional precedent, declaring October 31st a public holiday in honour of “the evangelical and Protestant churches”. It marks the date in 1517 when Martin Luther pinned his 95 theses to the door of a church in Wittenberg, Germany, starting the Protestant Reformation. Only Slovenia and some German states take it as a holiday.

What makes the decision to celebrate the Reformation odder is that Chile is the only country in Latin America that still has a significant (Catholic) Christian Democrat party. Nevertheless, the new holiday was approved by a unanimous vote in Congress. The politicians seem to have spotted an opportunity.

In the latest census in 2002 in a once staunchly Catholic country, 15% of Chileans said they were “evangelicals” (a synonym in Latin America for Protestants). State schools now offer a choice of Catholic and evangelical religious teaching, and the armed forces have chaplains from both denominations.

Chile is not alone. More than 15% of Brazilians and over 20% of Guatemalans are now evangelicals. Most Latin American Protestants are Pentecostals, stressing direct experience of God. Pentecostal churches continue to multiply in poorer areas of Santiago, as they do across the region. A former Catholic bishop and liberation theologian was elected as Paraguay’s president this year. But the embrace of Protestantism by Latin America’s socially aspirational poor looks like an inexorable trend. Five centuries after the region’s forced conversion to Catholicism, Chile’s new holiday is a cultural milestone.

It comes at a price. Chile may have a reputation as boringly hard-working, but now has 16 public holidays a year (plus the “bridge” days that Chileans tack on when a holiday falls near a weekend). A workday’s production is worth some $735m in lost output. So the government wants quietly to drop two of three holidays dedicated to the Virgin Mary.

Taiwan and China

Resisting China's charm offensive

Nov 6th 2008 | TAIPEI
From The Economist print edition

Rather than bringing unification closer, new economic ties solidify the status quo

AFP



CHIANG PIN-KUNG, who heads the Straits Exchange Foundation (SEF), the body through which Taiwan talks to China, called it “a key moment” and a “win-win economic situation”. The arrival in Taiwan on November 3rd of his mainland Chinese counterpart, Chen Yunlin, offered a ray of hope for the island’s faltering economy. Mr Chen, the highest-ranking visitor from China since the end of the civil war in 1949, came to sign a slew of business agreements. But for Taiwan’s president, Ma Ying-jeou, the visit was a gamble.

Supporters of the opposition Democratic Progressive Party (DPP) dogged Mr Chen’s footsteps, with protests accusing Mr Ma of selling out to the Chinese. Thousands of police were deployed to control the demonstrators, but failed to stop them besieging Mr Chen during a banquet in Taipei. His meeting with Mr Ma was rescheduled to fox protesters. Last month Mr Chen’s deputy was assaulted by DPP activists in southern Taiwan. The DPP’s traditional support for formal independence helps explain China’s fondness for Mr Ma, of the Nationalist Party, or Kuomintang. Since he succeeded the DPP’s Chen Shui-bian in May, China has oozed charm.

The latest agreements offer more substantial business ties than ever before. Most eye-catching is a big expansion of direct transport links. A new direct air route, avoiding Hong Kong’s airspace, will reduce travel time from Taiwan to Shanghai by over an hour, and save an estimated 40- 50% in fuel costs. Passenger charter flights, at present limited to 36 round-trips each weekend, are to become daily and increase to 108 a week. The number of flight destinations in China will increase to 21 from five, and there will be 60 round-trip charter cargo flights each month. There will also be new direct sea links, with 11 ports in Taiwan and 63 in China open to ships from the other side.

All this should delight Taiwan’s businesses, which have long pushed for direct links. The government estimates that they have invested over $150 billion in China. But the absence of direct links marginalises Taiwan from global supply chains. Wang Lee-rong, of the Chung-Hua Institution for Economic Research, a semi-official think-tank, insists the agreements “are not only symbolic, but will have real impact.” They might help not just Taiwan and China, she says, but the regional economy as a whole. This appeals to Mr Ma at a time when his popularity is slumping, as Taiwan is battered by global financial turmoil.

Despite the protests against Mr Chen's visit, Andrew Yang, of the Chinese Council of Advanced Policy Studies, a think-tank, says most Taiwanese do not see the agreements as surrender to China. Mr Ma's standing, he argues, depends on whether they can actually revitalise the economy. If global turmoil continues to drag down Taiwan's economy, he says, it may stay in the doldrums.

For China, the economic accords form part of a broader push to burnish its image in Taiwan. It has even employed one of its traditional courtship rituals by offering a Taiwan zoo a pair of giant pandas—popular with the public, though the Chen administration turned down an earlier offer.

Despite the talk of warming ties, both sides have to walk on political eggshells. China cannot stomach anything that hints at separate statehood for Taiwan. So when he met Mr Ma on November 6th, Mr Chen could not bring himself to call him "president". And Mr Ma, conscious that there is hardly any popular support in Taiwan for imminent unification with China, has also refrained from overtly political statements. Fudging the issue of Taiwan's status, he has described its ties with China as "special relations between two regions".

He has argued that setting political differences aside will allow the two sides to build mutual trust. This, he hopes, may even lead to broader negotiations on lowering political and military tensions, where, as he reminded Mr Chen, the two sides "have their differences and challenges". This week Lai Shin-yuan, of Taiwan's advisory Mainland Affairs Council, said she had urged Mr Chen in a closed-door meeting to remove China's military threat. She did not reveal his response. But Mr Ma's avowed goal of a peace treaty seems distant. It would depend on China's removing the estimated 1,400 missiles it has pointing at Taiwan, which China would not agree to do without a big reciprocal concession from Taiwan. And, unlike the economic talks, which can be handled through notionally "non-governmental" bodies, it would require direct official talks, with all the headaches that would entail.

China, however, may be content with this impasse. In recent years, even during Chen Shui-bian's rule, Chinese officials have shown far greater willingness to leave Taiwan be, as long as it resists any formal declaration of independence. The accords on cross-strait transportation give China's leaders a chance to show hardline nationalists that their tactics are working. With President Hu Jintao and the prime minister, Wen Jiabao, constitutionally required to step down in 2013, they may be more than happy to leave solving the Taiwan puzzle to their successors.



China and Sudan

There be dragons

Nov 6th 2008 | BEIJING
From The Economist print edition

A grim reminder of the dangers of international engagement

AFP



FIVE boxes draped in blue cloth arrived in China from Sudan on November 5th. The ashes they bore were of dead oil workers, victims of what China's foreign minister, Yang Jiechi, called one of the most serious cases in recent years of Chinese citizens being killed abroad. As China's overseas investments grow, its companies are learning the hard way what is meant by "country risk".

It is only this decade, when Chinese leaders have encouraged companies to "go out", that China's outward investment has taken off. Much of it has entailed a scramble for resources, often in conflict-torn areas. Chinese companies, which used to think of kidnappings and terrorist attacks as problems mainly for their Western rivals, are finding that they are targets too. Their risk-assessment and security-management skills are failing to keep up.

Details of the incident in Sudan are still sketchy. It is known that nine employees of China National Petroleum Corporation, a state-owned company, were kidnapped on October 18th in an oilfield in South Kordofan, in the volatile borderland between north and south. Nine days later five of them were killed. Sudanese and Chinese officials blamed the kidnappers. The Chinese press has also noted reports that the assailants might have panicked at the sight of a Sudanese military aircraft. A senior Sudanese official quoted on state-owned radio said the attackers' target was Sudan's "strategic relations with China".

Life is getting ever riskier for Chinese workers in dangerous countries. This was the third attack against Chinese-invested oilfields in Sudan in the past year. In August two telecoms engineers were taken hostage by Taliban militants in Pakistan (they escaped in October, but one was recaptured). In Nigeria Chinese have been among the more than 200 foreigners kidnapped over the past three years. In April 2007 nine Chinese were killed when gunmen attacked an oilfield in Ethiopia. The grim list goes on.

Assessing political risk in other countries is a sensitive business in China. Officials worry about upsetting diplomatic partners (relationships with resource-rich countries such as Sudan are among those most carefully nurtured). It was not until 2005 that the first comprehensive country-risk report was published in China, by Sinosure, a state-owned provider of export-credit insurance (eg, to Chinese businesses in Sudan). Sinosure's Liang Zhidong said last year he did not believe the conflict in Darfur posed a great risk to Chinese investments. Its significance, he said, was being "intentionally exaggerated".

Unsurprisingly, some Chinese firms are beginning to turn to Western risk and security consultancies for advice. But many, untrammeled by public opinion at home, where Sudan, for example, barely registers as an issue, see the risk as a price that has to be paid. Western businesses, they complain, have snapped up the least risky deals, leaving Chinese latecomers little choice but to venture into conflict zones.

In Sudan, China's cosy relationship with the government is clearly one reason why it is a target for militants. The Chinese foreign ministry tried to enhance its ability to predict and respond to such threats by setting up a department of external security affairs in 2004. But it shows no enthusiasm for using China's diplomatic clout to try to resolve internal conflicts.

Yet Chinese state-run television, in a recent programme titled "Hostage Crisis Abroad, China's Cautious Response", suggested one reason why risks were growing for Chinese citizens overseas: China's growing international influence. As China's rise continues, its understanding of the security predicament that goes with being a superpower may yet improve.

Tibet

Britain's suzerain remedy

Nov 6th 2008
From The Economist print edition

To control Tibet's future, China extends control over its past

IT WAS an early-21st-century solution to an early-20th-century problem. On October 29th, at the end of a short statement published on his ministry's website, Britain's foreign secretary, David Miliband, quietly junked his country's long-standing position on Tibet. Uniquely among the world's countries, Britain had not explicitly recognised Chinese sovereignty over the region. Rather it acknowledged its "suzerainty".

Quite what the term means has been obscure even to British diplomats. But what it does not mean—that China enjoys full sovereignty over China and has done so for centuries—has been enough to irk Chinese officials. It bolstered claims that Tibet was not part of China until its troops occupied it in 1951.

AP



A middle way for the Middle Kingdom

Mr Miliband describes Britain's old position as "based on the geopolitics of the time"—ie, the early 1900s, when British adventurers were entering Tibet from India and the Qing empire was disintegrating in China. He says this "anachronism" has "clouded" Britain's ability to get its points across on Tibet: on the importance of respect for human rights and of greater Tibetan autonomy.

His officials say he has merely aligned Britain's stance with that of its European Union partners and of America. They point out that even the Dalai Lama, Tibet's exiled spiritual leader, argues not for Tibetan independence, but for a "middle way" of greater autonomy within China. But that, in fact, is rather reminiscent of some definitions of "suzerainty". And the Dalai Lama has never admitted, as China would like, that Tibet has always been "an inalienable part of China". Arguing about its past status, he has insisted, is beside the point.

Moreover, he has recently shown signs of exasperation with his 20-year pursuit of the middle way. With his envoys in Beijing this week for an eighth round of talks with China since 2002, the Dalai Lama has said his trust in China's good faith is "thinning, thinning, thinning". His conciliatory policies have faced mounting criticism from Tibetans since bloody riots in Tibet earlier this year. A meeting later this month in Dharamsala, his seat in northern India, is to review his exiled government's stance.

Curiously, Mr Miliband's statement does not, in so many words, recognise Chinese sovereignty. But officials say it means that, as far as Britain is concerned, "Tibet is part of China. Full stop." For many Tibetans, however, the correct punctuation remains a question-mark.

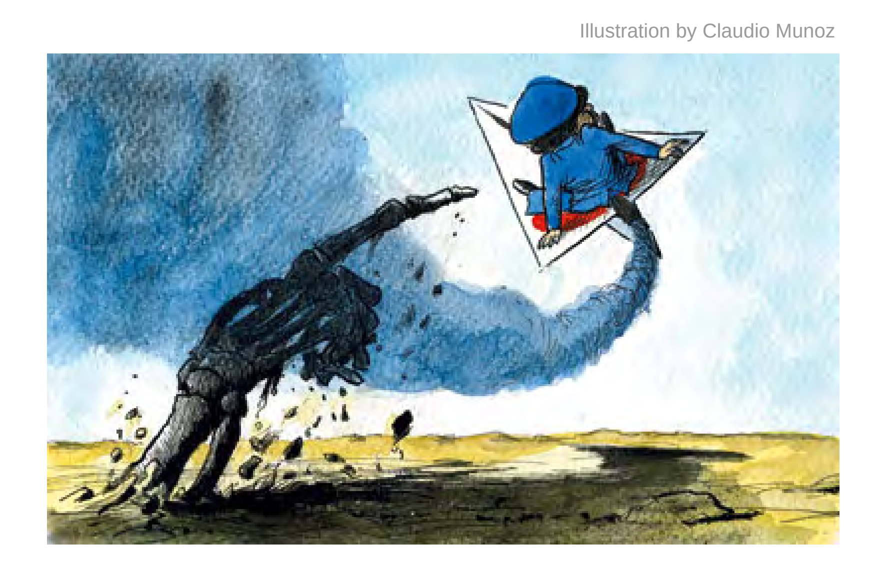
Japan and its history

The ghost of wartimes past

Nov 6th 2008 | TOKYO
From The Economist print edition

The history wars erupt afresh, with consequences for the country's prime minister

Illustration by Claudio Munoz



MANY Japanese were surprised that a hotel chain, under a cloud for shoddy earthquake-proofing standards, should sponsor a competition for the best essay to deny Japan's wartime role as an aggressor and sponsor of atrocities. But then the chain's boss, Toshio Motoya, is a vigorous historical revisionist (and big supporter of Shinzo Abe, prime minister in 2006-07). More astounding, then: the competition winner, Toshio Tamogami, was none other than the head of Japan's air force.

Mr Tamogami's offering is a warmed-through hash of thrice-cooked revisionism. Japan, he writes, fought a war of self-defence, protecting its legal territories of Manchukuo (North-East China) and Korea against communists. Pearl Harbour was an American-laid trap. Japanese occupations were both benevolent and a liberation of Asia from the yoke of Western imperialism—indeed, neighbours (20m of whose deaths were caused by the Japanese) now look fondly on wartime Japan. Japan must "reclaim its glorious history", Mr Tamogami ended with a barrel-rolling flourish and a want of irony, "for a country that denies its own history is destined to fall."

The prime minister of six weeks, Taro Aso, from the Liberal Democratic Party (LDP), moved swiftly. Within hours of the essay's publication on October 31st, Mr Tamogami, a general, was out of a job. China and South Korea expressed shock at his views, but accepted that they did not reflect the government's. Mr Tamogami did not help his case by complaining that Japan's freedom of expression was on a par with North Korea's. As well as the ¥3m ($30,000) essay prize, he gets a ¥60m retirement bonus from the defence ministry.

End of story? Not quite. For a start, Mr Tamogami, it transpires, took Mr Motoya for a joy-ride in a fighter jet. And since his sacking, it turns out that of the 230-odd aspiring writers of historical fiction, 78 were officers in Japan's air force, most of them close to their general. Of course, it is understandable that some professional warriors might chafe at Japan's American-dictated pacifist constitution; and at a victor's interpretation of history that discredited Japan's proud armed forces. But for so many to write revisionist claptrap in a hotel-sponsored competition is rum indeed. The unfortunate impression is of those radicalised officers' messes of the 1930s, out of which the Japanese army mugged civilian rule: the rest was, well, history.

So the prime minister has some explaining to do, and the opposition Democratic Party of Japan will make all the hay it can. It wants Mr Tamogami to testify before the Diet. It may press the prime minister about his own views. His government, like its predecessors, endorses apologies, first formulated in the mid-1990s, expressing guilt and remorse for wartime suffering. In office (and as foreign minister before that)

Mr Aso has also eschewed visiting Yasukuni, where war criminals as well as Japan's 2.5m war dead are enshrined.

Yet in the past Mr Aso, in a shoot-from-the-hip way, has echoed many of Mr Tamogami's right-wing views. He has, for instance, praised Japan's occupation of Korea from 1910-45, even though his family fortune derives from a mining company that used Korean slave labour during the second world war. As prime minister Mr Aso has been on good behaviour. Yet the day after Mr Tamogami's sacking, he casually picked up a volume of views similar to the general's from a Tokyo bookstore.

Mr Aso is certainly doing his bit to improve tricky relations with neighbours, China and South Korea in particular. Unlike many revisionists, he embraces the post-war order, wants an internationalist role for Japan, and does not see bogeymen behind every tree. Yet now he has the challenge of reassuring Japan's neighbours over the Tamogami affair without undermining his own conservative base.

The public reaction to the affair reinforces how beleaguered these days are Japan's history-deniers, says Jeffrey Kingston, a historian of Asia at Temple University in Tokyo. Even Yasukuni has toned down the exhibits in its notorious museum, where until recently militarism was celebrated and all atrocities denied. The most notable denial was of the Nanjing massacre of tens (or possibly hundreds) of thousands of Chinese in December 1937. Now the museum admits that killings took place, but suggests they were of enemy soldiers disguised as civilians. This is the problem with the historical fantasists. Even as they moderate their public message, they leave you waiting for the “but”.

 WORLD ASIA

Bangladesh

The nice side of democracy

Nov 6th 2008 | DELHI
From The Economist print edition

Shame about the democrats

IN JANUARY 2007 Bangladesh's generals marched into the palace of President Iajuddin Ahmed and forced him to cancel elections, declare a state of emergency and appoint a government of technocrats. On November 3rd Mr Ahmed at last signed an order sending the army back to the barracks. The interim government also lifted restrictions on political campaigning and the press. Bangladesh's state of emergency—the longest any South Asian country has endured—seems to be petering out.

So firm are the commitments by the generals to hold parliamentary elections that a return to multiparty democracy appears a certainty. This week the Election Commission confirmed that a general election would be held on December 18th. This followed assurances by the army to the UN secretary-general, Ban Ki-moon, on a two-day visit to Dhaka, that this time it would not interfere.

The front-runners in the race to succeed a period of muddled rule by soldiers, spooks and technocrats are the heads of two feuding dynasties whose careers the army tried and failed to end: the former prime ministers Sheikh Hasina Wajed of the Awami League and Khaleda Zia of the Bangladesh Nationalist Party (BNP). The two women rotated in power for 15 years from 1991. Their mutual hatred and inability to negotiate played a big part in turning Bangladeshi politics into a prolonged cycle of violent retaliation.

Even so, the view of the army, Bangladesh's foreign aid donors and its voters is now that the "two begums" constitute the only offer on the table. The army tried to send them into exile, hoping new political parties would emerge; then it jailed them and their coteries on charges of corruption. In the end, they were freed on bail. It proved impossible both to hold them to account and to hold elections.

The League is confident it will win the vote. Greeted by large crowds, Sheikh Hasina came back to Bangladesh on November 6th, five months after being freed to receive medical treatment in America. The rival BNP is split and, much harder-hit by the anti-corruption drive, is in a shambles. As the League started its election campaign this week, the BNP was still debating whether to take part. Mrs Zia alleges that the Election Commission favours the League and should resign.

Meanwhile, the army appears to have resigned itself to Sheikh Hasina's becoming the next prime minister or, at least, contesting the elections. For her part, having narrowly escaped an attempt on her life in 2004, she may feel that only the army can protect her from her political rivals. The generals want their state of emergency legitimised, and immunity from prosecution. These are concessions the League is probably willing to make, if not to advertise.

The court cases against the two prime ministers have in effect been put on hold until the election. If the past is any guide, the next government will control the judiciary, so convictions will never happen. Observers believe that endless behind-the-scenes talks with the leaders, aimed at bringing their parties to the polls, are likely to have included guarantees by the two ladies not to put the losing rival in prison.

Yet, barring upsets, more than 80m Bangladeshis will next month be allowed to choose a government for the first time since 2001. And the election has a better chance of being credible than any since independence in 1971. The Election Commission has purged 12m surplus names from voter lists. The authorities claim the poll will be almost impossible to rig.

What Bangladeshis still do not know is whether the army's intervention has shocked the country's squabbling, petty politicians into a new approach. The world's seventh-most populous country needs a government devoted not to a perennial political vendetta, but to tackling poverty, climate change and terrorism.

The war in Pakistan

Predator and prey

Nov 6th 2008 | ISLAMABAD
From The Economist print edition

Allies at odds over missile strikes

AHEAD of America's election, Pakistan's prime minister, Yusuf Raza Gilani, exhorted both candidates to stop launching missile strikes on Pakistani soil as part of America's campaign against Taliban insurgents in Afghanistan. Mr Gilani said the attacks were fanning anti-American sentiment and undermining his government's efforts to combat terrorism. General David Petraeus, in Pakistan this week as part of his first foreign trip since taking charge of America's Central Command, was also given a slap on the wrist.



Mr Gilani said the general had "looked convinced". But the strikes are unlikely to stop under Barack Obama (see article). The *Washington Post* has reported that a secret deal between America and Pakistan would allow better co-ordination of Predator drone attacks. The agreement, made in America in September by Pakistan's president, Asif Zardari, included a jointly approved list of senior targets. There have been over 30 American missile strikes this year, mainly in Waziristan (see map). They have claimed a number of al-Qaeda scalps, reportedly including that of the outfit's number four, Khalid Habib, last month. Another mid-level Osama bin Laden acolyte was among 27 killed on October 31st in one of two separate missile attacks. Western diplomats claim that the strikes have become more accurate. Pakistani officials question this, pointing to a high toll in civilian deaths. Mr Zardari complained to General Petraeus that the missile strikes were creating a "credibility gap".

The government is a coalition led by the Pakistan People's Party (PPP), whose leadership Mr Zardari inherited from his late wife, the assassinated former prime minister, Benazir Bhutto. It has so far failed to articulate a coherent counter-terrorism policy. Last month parliament passed a vague resolution calling for dialogue with militant groups and an end to military action. But its fatuous slogans about Pakistani unity in the face of incursions and invasions failed to generate any sort of consensus. The opposition, led by the party of another former prime minister, Nawaz Sharif, demanded to know the basis of the "secret deal" with America.

Worryingly for the army, the missile strikes may scupper controversial peace deals struck with militants in North and South Waziristan. As General Petraeus began his visit, a suicide-bomber rammed a car into a checkpoint near Wana, in South Waziristan, killing eight soldiers. Officials say that the army cannot afford to launch operations yet against militants lurking in Waziristan's badlands. It is overstretched by operations in Bajaur, another tribal area, and the former holiday-resort valley of Swat, in North-West Frontier Province.

The army says it has killed more than 1,500 militants in Bajaur since August. As evidence of success it points to a Bajauri tribe that has raised a militia, or *lashkar*, against the Taliban, and says this experiment

has been replicated in several other parts of the frontier. Yet up to 300,000 people have had to flee the fighting in Bajaur. Most of the refugees, embittered by the operation, face a harsh winter in tented camps. A Western military official reckons the army is faring worse in Swat, where militants hold their own. This week they abducted 12 schoolchildren, whom they later freed unharmed.

Pakistani officials describe the army's policy as one of containment. The mainstream Pakistani view, which was echoed at an Afghan-Pakistani mini-*jirga*, or tribal council, held last month in Islamabad, is that the region will remain volatile as long as Western troops remain in Afghanistan. But Western generals pin ever more of the blame for the Taliban's resilience on the tribal areas of Pakistan and the refuges, supply bases and recruiting grounds they provide. So for now they seem as likely to step up the pressure there as to ease it.



WORLD
ASIA

Pakistan and Barack Obama

Barracking

Nov 6th 2008 | LAHORE
From The Economist print edition

Where Obamamania does not apply

THE global carnival sparked by Barack Obama's election victory suggests unrealistic faith in his ability to change the way America deals with the world. But in Pakistan people are less drawn to the lofty rhetoric of change than they are repelled by another campaign pledge.

Mr Obama has said that when elected he would authorise cross-border operations to “hunt down” Taliban and al-Qaeda militants operating in the tribal areas of Pakistan. But as the drone missile attacks—and attendant civilian deaths—have mounted (see article), they have fired up both rural radicals and urban, middle-class moderates, whose national pride is wounded.

In Lahore students at the best colleges are well aware that the president-elect has an Arab middle name and a Muslim grandfather. Some even believe he prays five times a day. But they still ask why, if Mr Obama is the new broom he claims to be, does Pakistan face the prospect of American boots and bombs on its soil. Their doubts were manifest in a recent opinion survey of 24 countries: Pakistan was one of only four where those polled expected a turn for the worse under the new president.

As some savvy students point out, the aggressive posture may have been a ploy to win conservative votes. And Talat Massoud, a former general turned analyst, sees hope in Mr Obama's remark this week that resolving Pakistan's dispute with India over Kashmir will be a focus. That, he says, shows a more nuanced understanding of regional dynamics. Not to mention optimism.



WORLD
ASIA

Malaysia

Enter Najib, with baggage

Nov 6th 2008 | BANGKOK
From The Economist print edition

A new leader mired in accusations

ONE could certainly say that Najib Razak was born to be Malaysian prime minister. He is the son of Abdul Razak, the second man to hold that job following independence from Britain, and the nephew of his successor, Hussein Onn. Elected to parliament aged 23, on his father's death, he rose to become deputy to the present prime minister, Abdullah Badawi. However, Mr Najib, expected within months to become the country's sixth post-independence leader, will enter under a cloud of allegations, including ones linking him to a murder case, all of which he categorically denies. But some Malaysians will be wondering if he is a fit person to lead them.

Facing a revitalised opposition, in an election earlier this year the governing coalition, led by the United Malays National Organisation (UMNO), lost the two-thirds majority it needs to change the constitution. Since then, the knives have been out for Mr Badawi. Despite his efforts to cling on he is being forced to quit next March. The contest to succeed him as party president, and thus prime minister, at first promised to be lively. But party officials, fearful of the challenge from the opposition leader, Anwar Ibrahim (a former UMNO deputy leader), chose to hang together rather than hang separately. By November 2nd Mr Najib had won enough nominations to block his only rival, Razaleigh Hamzah, a former finance minister, from getting on the ballot-paper.

Bloomberg



The quizzical Mr Najib

Like Mr Badawi before him, Mr Najib comes to the job promising reforms, including of the system of preference for members of the ethnic-Malay majority for state contracts and jobs. Mr Badawi achieved little, though he allowed a bit more freedom of expression than had his predecessor, Mahathir Mohamad. Expectations for Mr Najib are lower still. It is possible, notes Edmund Gomez, a political scientist, that he will use the worsening economic outlook as a pretext for reverting to Mahathir-style repression.

Mr Anwar has failed to carry out his threat to topple the government through a mass defection of parliamentarians. Even so, there is a palpable *fin de régime* air around UMNO. Mr Badawi, Mr Mahathir and other leaders are publicly lamenting how corruption and cronyism are rife in the party. But his opponents say Mr Najib is hardly the man to restore confidence. In the latest scandal to which they are linking him, the defence ministry (which he oversaw until recently) has deferred a big order for helicopters following questions about their high price. A parliamentary committee this week cleared the government of wrongdoing, but admitted not investigating whether “commissions” were paid.

In an earlier case, a company the opposition claimed was linked to Razak Baginda, an adviser to Mr Najib, was paid juicy fees for services provided over a contract for the purchase of French submarines. A Mongolian woman, said to have worked as a translator in the negotiations, was shot dead and her corpse destroyed with explosives in 2006. Mr Razak was put on trial over her killing, along with two policemen. The case has dragged on for months and seen various odd goings-on, including changes of judge, prosecutors and defence lawyers at the start of the trial. A private detective signed a statutory declaration implicating Mr Najib, retracted it the next day, saying it had been made under duress. Calls by the victim's family for Mr Najib to testify were rejected. On October 31st the judge ruled that the prosecution had failed to make a prima facie case against Mr Razak.

The policemen's trial will continue. A blogger who linked Mr Najib's wife to the case is on trial for criminal libel. None of this, however, seems likely to interfere with Mr Najib's accession to the prime minister's job. A bigger threat may yet emerge from the resurgent opposition and Mr Anwar, who nurtures a long-thwarted ambition to take the job himself.

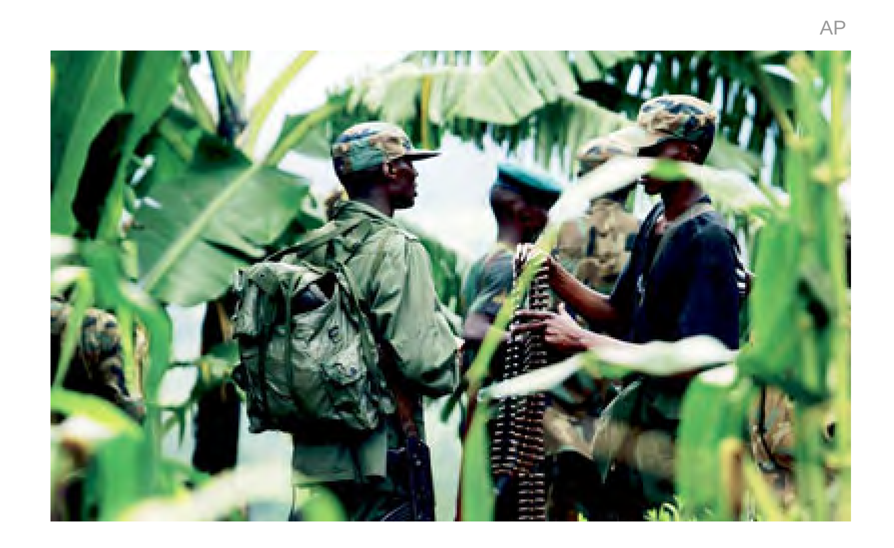
Congo

Murder, muddle and panic

Nov 6th 2008 | KINSHASA
From The Economist print edition

As chaos and massacres overwhelm north-eastern Congo, diplomats and peacekeepers are struggling to get a grip

AP



“THE situation is catastrophic,” says a Red Cross man. “There’s no other word.” Tens of thousands of terrified civilians are jamming the roads of Congo’s North Kivu province in a frantic southbound exodus in the hope of self-preservation (see map). General Laurent Nkunda’s mainly Tutsi rebels are poised to grab the eastern city of Goma after capturing most of the smaller towns in the area. Reports of massacres on the night of November 5th in Kiwanja, a small town north of Goma, have increased the panic. An officer in General Nkunda’s force said that his men had “neutralised” men in civilian clothes there who, he said, covertly belonged to the so-called Mai-Mai militias; they, along with the Congolese army and others, have been fighting the Tutsi rebels. A local clergyman said at least 180 civilians had been killed during the night.



The UN’s mission to Congo, known by the acronym MONUC, which has 17,000 peacekeepers across the country, including 6,000-odd in North Kivu, has been unable to cope. Diplomacy, hitherto fruitless, is intensifying. European diplomats, led by the foreign ministers of Britain and France, David Miliband and Bernard Kouchner, have visited regional capitals, calling for talks and troop reinforcements. The UN

secretary-general, Ban Ki-moon, was set to host a summit on November 7th in Nairobi, Kenya's capital, bringing together the presidents of Congo and Rwanda, Joseph Kabila and Paul Kagame respectively, who have been sponsoring some of the rival rebel armies. Nigeria's former president, Olusegun Obasanjo, has been tapped as a mediator; he immediately called for MONUC to be beefed up. The French government suggested that a robust European force of 400 to 1,500 soldiers be dispatched urgently to protect the humanitarian missions that are struggling to give relief to hundreds of thousands of hapless and hungry civilians. So far the European Union has been loth to give the go-ahead.

In the past two years, some 850,000 people have fled their homes due to fighting between the rebels, Congo's army and assorted militias. Though General Nkunda launched his latest offensive in August, his 4,000 or so battle-hardened fighters have been lording it over the area for four years, claiming to champion the rights of eastern Congo's Tutsi minority. But the root of the problem goes back to the genocide of 800,000 Tutsis and moderate Hutus in Rwanda in 1994. If a wider regional peace is to be achieved, an accommodation between the surviving former victims and their exiled persecutors must be arranged.

After the genocidal Hutu militias were chased out of Rwanda, they fled to Congo, called themselves the Democratic Front for the Liberation of Rwanda (FDLR), and have marauded in North Kivu ever since. Successive weak regimes in Kinshasa, Congo's distant capital, have used them as a tool, first against a Rwandan intervention that helped spark a wider conflict from 1998 to 2003. Congo's President Kabila is now using them as proxies against General Nkunda's National Congress for the Defence of the People (CNDP). Mr Kabila's failure to rid eastern Congo of the Hutu *génocidaires* has nourished General Nkunda's own brand of Tutsi extremism. Mr Kabila has also winked at local militias, including the Mai-Mai, who have been fighting General Nkunda's men too.

Neighbouring Rwanda is also culpable. Its government has repeatedly endorsed various demands of the general, who refuses to register his group as a political movement in Congo, eschewing the UN-sponsored elections there two years ago. Instead, Rwanda's President Kagame has pursued a contradictory policy, telling Mr Kabila to squash the Hutu rebels of the FDLR but refusing to meet the FDLR's demands to have a legal stake in Rwanda's politics. If Mr Kagame let it do so, many of the FDLR fighters, especially those who did not play known roles in the genocide, would probably go home.

Western governments have been in a muddle. They have economic and historic interests in the region; they feel bad about letting atrocities take place in the past; and they have their own protégés whom they sponsor and fail to denounce when they behave badly. As a result, the governments of Congo and Rwanda have been on a collision course. Outsiders have also failed to turn Congo's lousy army—a hodgepodge of Mr Kabila's loyalists, former rebels and militias—into a disciplined fighting force capable of nailing the Hutus' FDLR.

Congo's President Kabila may have to meet General Nkunda's demand for direct negotiation, simply because the Tutsi rebels are militarily dominant; indeed, Mr Nkunda has threatened to "march on Kinshasa" unless Mr Kabila meets his basic demand to clobber the Hutu rebels of the FDLR. Meanwhile, the UN Security Council will again be asked to strengthen MONUC's mandate so that it can suppress all illegal armed groups in the area, should talks fail again. The most immediate requirement is for Messrs Kabila and Kagame to sit down together and talk.

South Africa

A new party

Nov 6th 2008 | JOHANNESBURG
From The Economist print edition

Can it loosen the rulers' grip?

EPA



Lekota: making a stand for "values"

THE African National Congress may face its first serious black-led opposition since it began to run South Africa after apartheid ended in 1994. Some 6,000-plus disillusioned ANC supporters from all walks of life, gathering in Johannesburg on November 1st, decided that a new party would be formally inaugurated next month. Other opposition leaders, such as Helen Zille of the mainly white-led liberal opposition, the Democratic Alliance, attended the jamboree, excited by cracks in the ANC's domination, and talked of joining forces. But with no name, no clear policy and no party structure, the new outfit is far from certain to dent the ANC at the general election due in April. Last time, in 2004, the ruling party got 70% of the vote to the Alliance's paltry 12%.

Tension had been brewing in the ANC before and after its leadership contest in the northern town of Polokwane last December. Thabo Mbeki, then the country's president, lost the ANC's top spot to Jacob Zuma, who is expected to become the country's president when Parliament picks one after a general election in April. But the last straw for many disillusioned ANC people was when their party's new leadership asked Mr Mbeki to step down as South Africa's president in September. After bowing out, he has stayed on as an ANC member. But several leading lights, notably Mosiuoa ("Terror") Lekota, a former ANC chairman, and Mbhazima Shilowa, until recently the premier of Gauteng province, which includes Johannesburg, decided to break away to form a new party.

They say Mr Zuma and the ANC's new bosses are undemocratic and intolerant, though they themselves were silent when, in years past, Mr Mbeki branded critics as racist and falsely accused rivals of conspiracy. Moreover, it is unclear what the new lot stand for. A main theme at its convention was the need to elect the country's president directly, not by a vote in Parliament. Many said lawmakers should be elected in constituency contests, not by party lists, as happens now. Others called for respect for the constitution and equality before the law: a veiled attack on Mr Zuma, who still faces corruption charges.

A clear programme may not be necessary to win votes. Some of the breakaway group say their party will defend "ANC values". Others complain that the ANC has been taken over by its Communist and trade union allies. The new movement's "Shikota" duo, as the leadership has been dubbed, says it wants to reach beyond the ANC's old base. Some black businessmen and professionals sound interested. The new group seems to have cash. It may be able to take over the ANC machinery in some areas but, with time short, may struggle to compete against the ruling party's electioneering muscle on a national scale.

Its real hope, at first, is to reduce the ANC's majority and, perhaps in coalition with other opposition parties, to make gains in provincial government, especially in the Western Cape, where the Democratic Alliance is strong; Ms Zille is the mayor of Cape Town. An injection of competition should enliven South Africa's democracy. But it could also make it uglier. Already ANC militants have harassed and intimidated supporters of the new party.

Africa

Jet-setting to business as usual

Nov 6th 2008 | SOMEWHERE OVER AFRICA
From The Economist print edition

Afro-boosterism seen from on high

Illustration by Peter Schrank

IT IS too easy to see Africa as little more than an amalgam of hut-burning *janjaweed* militias, emaciated children and "big men" in aviator shades. Africa's civil wars, sham elections and political shenanigans certainly demand attention, so the remoter parts of Darfur, Ethiopia, the Niger Delta or Zimbabwe tend to be where Western reporters end up, often after dangerous journeys in elderly planes and bumpy jeeps. The view was different when your correspondent was whisked around six rather more salubrious countries in five days in a Gulfstream 5 executive jet carrying a clutch of managers and investors with Lonrho, a London-based company with a controversial history in Africa.

Up there, in the rarefied atmosphere of jet-set investor group-think, Africa's wars and diseases can dissolve all too easily in a glass of Chablis too many, as executives talk frontier funds and business possibilities. Individual countries blur into little more than a succession of food-processing plants, PowerPoint presentations and container ports. Wednesday? It must be Mozambique. Or is it Congo? Hard at first to tell, as you glide through customs and passport control with barely a murmur from the usually finickety officials. This must be how big men travel. It is seductive.

Touring Africa with Lonrho carries a cachet of its own. It is one of the most recognisable brands in Africa, the legacy of the redoubtable Roland "Tiny" Rowland, who built the company up over more than three decades from its modest beginnings in Southern Rhodesia (now Zimbabwe) before being ousted in a boardroom coup in the mid-1990s. At its height, Lonrho had 680 companies across Africa, run from offices in Nairobi. Company legend has it that at one point its firms made up 40% of Zambia's GDP—even the omnipresent Chinese cannot match that nowadays.

The swashbuckling Rowland died in 1998 and his empire was broken up. The mining bit—the most profitable—became Lonmin. Lonrho's hotel portfolio was reduced to just one tatty hostelry, in Mozambique. Now, having taken over the rump company just three or so years ago, Rowland's successors are trying to build it back up, in a style that Tiny would surely have approved of. One of its liveliest new businesses is an airline in east Africa, Fly 540.

Rowland reckoned that in post-colonial Africa politics was everything—as it often still is. He made sure he was best mates with virtually every political leader on the continent, however unsavoury or crooked. This earned him vilification in Britain: a prime minister, Edward Heath, catchily dubbed Lonrho "the unacceptable face of capitalism". But in Africa it earned access to markets and government contracts. He was fêted by Africans because, unlike well-meaning aid agencies and foreign governments, Lonrho not only promised hotels, roads, ports and farms that would develop Africa, it actually built them.

Two decades on, the reincarnated Lonrho goes about business in some of the same jovial ways—but with a less spotty capitalist face. Instead of the charming Rowland, a boisterous Australian-born chairman, David Lenigas, with a girth as big as his ambitions, gladhands politicians wherever he goes. Many of the new businesses in Africa are joint ventures with governments or with people tied to the ruling parties. It is called reducing political risk. They are less likely to nationalise you if they already own you, argues Mr Lenigas. Another old Lonrho hand, brought back to run the hotels, argues that "Africa is all about relationships. Africa does not trust commerce—it's all done on relationships. It's the only way to succeed." A lesson the Chinese have learned all too well.

Always find your man

So we break bread and nurture our relationships in countries like sticky Equatorial Guinea, these days perhaps best-known for imprisoning Simon Mann, a posh British mercenary who tried to oust the government four years ago in a coup. We spend about seven hours there, just long enough to visit a Lonrho port facility, talk to Western oilmen who are making the ruling family very rich indeed, and listen to a quick sales-pitch from one of President Obiang Nguema's American-educated sons, the "go-to" man for investors. He tells us of his plans to turn the country into a sort of Switzerland of African tourism, with all that virgin rainforest to explore. Perhaps Mr Mann, as the country's most famous resident, could feature on the tourist trail. Messy facts about the awfulness of the government are politely ignored. This is after all, one of Africa's worst regimes, with an abysmal human-rights record and life expectancy under 50.

Other stop-off points are, like Equatorial Guinea, Africa's hottest investment destinations of the moment: Luanda, capital of Angola; Maputo, capital of Mozambique; and Lubumbashi, Congo's sprawling south-eastern mining city. These are the places that excite investors, where high returns are anticipated in countries often starting from scratch after years or even decades of civil war. Luanda, for instance, is now as much of a bottleneck as a gateway to Angola, as the world scrambles to pick up contracts from its burgeoning oil sector. The most impressive sight is not in town but from town, of scores of freighters and tankers waiting off-shore to enter the clogged harbour: it takes an average of 45 days to dock and three months to get a container out of the port.

Just another African business bubble, to be puffed up by the usual Western buccaneers? As financial turmoil hits the rich world, the investors in Lonrho spend a lot of time scrutinising their BlackBerries and calling out latest share and currency dives. Lonrho's own share price tumbled from £49 ($97) in January to £6 on October 27th. But, remarkably, the company's African interlocutors barely mention such things. Wall Street and the City of London seem a long way from Maputo, and the optimists hope that this very remoteness may turn out to Africa's advantage.

Back on the jet, Lonrho's chief executive says it is firms like his that will develop Africa, not aid money. Maybe. But Africa has a habit of confounding the empire-builders, as Tiny Rowland found out. As for your correspondent, he is now sweating in a tent in Sudan.

The Gulf states

Caught in the middle but still perky

Nov 6th 2008 | ABU DHABI, DOHA AND DUBAI
From The Economist print edition

Buffeted by ill winds from Iran and Iraq, and rattled by the world's financial turmoil, the Gulf states still look set to survive the troubles around them

AT THE heart of a region better known for tension and strife, and at a time of global financial anxiety, the rich Arab monarchies of the Gulf exude an unworldly calm. Their lucky citizens seem to inhabit an enchanted cocoon of marble-halled villas, hotels and shopping centres, awaft in costly scents, serviced by an obedient army of foreign workers and protected by the might of the American superpower. Amid such playthings as thoroughbred horses, hunting falcons, yachts, jets and flashy cars by the fleetful, Gulf rulers have pondered not how to stay in power but what new castles, towers and cities to build for their happy subjects.

Just now, according to one survey, they have some $2 trillion worth of mainly publicly-funded projects planned or under way, which may look excessive were it not that the size of the six national economies that make up the Gulf Co-operation Council—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates (UAE)—has tripled within five years to an overall GDP of close to $1 trillion.

Yet storm clouds loom over this air-conditioned Shangri-La. In the past six months the price of oil, the export commodity that underpins such fabulous wealth, has fallen by more than half from record highs. Local stock indices have tumbled in line with the rest of the world; the biggest, Saudi Arabia's, has fallen by 45% since the start of the year. The portfolio losses sustained by the Gulf's sovereign wealth funds, estimated a year ago to have accumulated some $1.5 trillion in overseas assets, may approach the $400 billion earned by the GCC from oil sales last year.

Small wonder that Gulf governments showed little enthusiasm when Britain's prime minister, Gordon Brown, who recently toured the region, asked them to stump up extra cash for the IMF, though Gulf investors have jumped in to prop up Barclays, a British bank, with an infusion of £5.8 billion ($9.4 billion) that could raise their share of its equity to more than 30%.

And while, with few exceptions, the Gulf monarchies face little short-term pressure for internal reform, geopolitical pressures are mounting. To the north lies Iraq, whose current relative calm carries little assurance of lasting. On the opposite shore of the Gulf sits the Islamic Republic of Iran, a testy Shia theocracy with nearly twice the GCC's population (70m-odd versus 38m or so) and a nuclear programme that most Arabs assume will sooner or later bear atomic bombs. A nuclear-armed Iran would not be a strategic counterbalance to the United States or Israel, says a think-tank man in the UAE's Dubai, reflecting official worries. "The weapon would be used only to intimidate us, the ones who have nothing."

Not only does Iran maintain that the Gulf is Persian in name. It also insists that its neighbours respect its own pre-eminence in the region, underscored by its success in penetrating Iraq and backing "resistance" forces such as Hizbullah, Lebanon's leading Shia party-cum-militia, and Hamas, the Palestinians' powerful Islamist movement. Sunni Arab monarchs fear that Iran may influence their own Shia citizens, who are repressed and restive in Saudi Arabia and Bahrain, an island kingdom where Shias are a majority and which some Iranians continue to claim should belong to them (see map).



Iranian officials have a habit of sounding such sour notes, amid a sweeter chorus of benevolence towards their once barefoot Arab cousins. In case of attack, they have openly threatened to hit the American bases that dot the GCC monarchies and to blockade “indefinitely” the strait of Hormuz, through which 40% of the world’s exported oil flows. More recently, Iran said it plans to build a new base on its side of the strait. Besides, its forces have sat for years in occupation of three disputed islands in the Gulf, bluntly rejecting calls by the UAE, which has a strong legal case for ownership, to settle the issue of sovereignty by international arbitration.

Such tensions are partly historic, reflecting ancestral animosity between Arabs and Persians, as well as Iranian ire at the Gulf Arabs for their generous funding of Iraq’s Saddam Hussein during the brutal slaughter of the Iran-Iraq war in 1980-88. The GCC was founded, in 1981, largely for the rich and sparsely populated monarchies to fend off revolutionary Iran, which scornfully labelled the group an American club—with some justification, since they have all, with varying degrees of openness, hosted American forces on their land.

But Iran’s prickliness also reflects a confidence that, although its Arab neighbours are under an American military umbrella, they are neither strong nor unified enough to oppose the Islamic Republic. Despite prodding to toughen their stance towards Iran, particularly from the Bush administration, the GCC states have for the most part preferred to leave diplomacy to their Western allies.

One reason is that some of them enjoy extremely lucrative economic ties with Iran. Dubai, the regional trading hub that is one of the UAE’s seven statelets, handles an estimated 60% of Iran’s merchandise trade, hosts nearly 10,000 Iranian-owned firms and is linked to Iran by more than 250 flights a week.

The Gulf Arabs have also been reticent because of political differences. Saudi Arabia, with its physical size and pretensions to Sunni leadership, has tended to adopt a harder line towards an Islamic Republic whose head of state, Ayatollah Ali Khamenei, styles himself supreme commander of the Muslims. But diminutive and ultra-rich Qatar, which happens to share a giant natural-gas field with Iran and whose leaders have often been at odds with their Saudi cousins, has had reason to be warier. Many of the smaller Gulf states have, until recently, quietly worried as much about Saudi Arabia, a state that was created by conquest under an extremist Wahhabi ideology, as about the more distant regional heavyweight over the water.

Uncle Sam’s clodhoppers

The Arabs’ discomfort with their superpower patron has been another reason for toning down differences with Iran. It is not only that America’s troop presence, which citizens of the smaller Gulf states tend to accept as a necessary evil, is unpopular. It is also that, under Mr Bush, America has ridden roughshod over Gulf objections to such policies as invading Iraq and backing Israel in its war with Hizbullah in 2006.

So, instead of helping their erstwhile American ally by, for example, moving to challenge Iranian influence in Iraq or loudly protesting against Iran's nuclear plans, the Gulf states have been largely passive. Countries such as the UAE have applied sanctions mandated by the UN Security Council against Iran, intended to punish it for failing to reveal the full extent of its nuclear programme and heed demands to stop enriching uranium. Yet they have continued to signal friendliness, to the point of inviting Iran's controversial president, Mahmoud Ahmadinejad, last year for a pilgrimage to Mecca and to attend the GCC's annual summit meeting. On October 28th the group's secretary-general, Abdel Rahman Attiya, made a first-ever visit to Tehran, reiterating support for Iran's right to peaceful nuclear technology and expressing hope for "cementing and consolidating" relations.

Yet there are signs that the Arabs' patience with Iran is thinning. Mr Ahmadinejad has pointedly not been invited back, so far, to the GCC leaders' meeting in February. For all his kind words in Tehran, Mr Attiya recently likened Iran's occupation of the three Gulf islands claimed by the UAE to Israel's occupation of Palestinian land.

Iranian businessmen have lately complained that it is harder for them to do business via Dubai, since ever-fewer banks in the free-trading emirate are willing to open accounts for them. Arab governments are now keener to engage with Iraq, opening embassies in Baghdad in a belated effort to bolster forces not aligned with Iran. Meanwhile, they have quietly smoothed over their own differences. A striking rapprochement between the region's diplomatic maverick, Qatar, and Saudi Arabia, has been marked by a toning down of criticism of the Saudis by the popular Qatari-owned television channel, al-Jazeera.

Privately Gulf Arab officials sound much harsher about Iran, reflecting increased doubt that either diplomacy or economic sanctions can block its nuclear ambitions. "If the military option happens [ie, if the Americans or Israelis bomb Iran's nuclear facilities], we will have no problem with that," asserts a Gulf security expert. "If we reach a point where the choice is living with a nuclear Iran or suffering the consequences [of an attack], we would choose the latter." Other analysts note that, despite the manpower imbalance between forces, Arab Gulf states are better equipped to damage Iran and resist counter-strikes. The UAE is due to become the first foreign country to deploy America's most advanced air-defence system, capable of destroying incoming missiles at a range of 200km (124 miles). Already, Arab air forces far outgun Iran's.

Poorer Persians

Sceptics of economic pressure on Iran may be proved wrong. In the GCC's open economies, the effects of global financial turmoil are plain. Places such as Dubai, highly leveraged and with a swollen property bubble, may suffer harder shocks in the near future. Still, all the Arab monarchies have giant cash cushions, the biggest one belonging to Dubai's generous sister emirate, Abu Dhabi. The GCC's ambitious government budgets can probably stay in the black, even with oil prices sinking towards $50 a barrel, or could be trimmed at prices well below that with little pain.

Iran, by contrast, has little spare cash after three years of Mr Ahmadinejad's spendthrift populism. With inflation nearing 30%, Iranians are already grumpy: witness a recent strike by bazaar merchants protesting against a plan to impose VAT, at 3%. Iran needs oil to stay at no less than $75 a barrel to maintain spending. While its isolation from the world economy, partly a result of sanctions, does provide a temporary buffer, a sustained decline in national income may yet focus minds on the cost of pursuing a nuclear programme that promises no benefit for many years to come.




Russia

Getting Medvedev's message

Nov 6th 2008 | MOSCOW
From The Economist print edition

A belligerent state-of-the-nation address from Russia's president

AFP



IT TOOK Dmitry Medvedev a while to find a suitable moment for his first state-of-the-nation address. The date had changed twice before the Kremlin settled for November 5th. This timing was meant to show that Russia's agenda is unaffected by such trivia as America's presidential election. But it also smacked of rival attention-seeking: even as the world listened to Barack Obama's victory speech, Mr Medvedev was laying out a Russian version of democracy. The main television news devoted 45 minutes to Mr Medvedev, leaving just five minutes for Mr Obama.

The two main events of the year, Mr Medvedev said, had been the August war in Georgia and the world economic crisis. And America bore responsibility for both. The war stemmed from the presumptuous policies of America's government; the economic crisis was a result of its arrogance and selfishness. It had ignored the advice of countries such as Russia and undermined everybody's financial markets. Yet Russia, he promised, will not back down in the Caucasus—and nor will it be pulled down by the economic crisis.

Mr Medvedev did not even refer to Mr Obama's victory in his speech, let alone congratulate him (he sent a telegram later). Indeed, he suggested that it was for America to make a move towards repairing its relationship with Moscow. He also offered a response to the expansion of NATO and the construction of missile defences in Poland and the Czech Republic. Russia will place short-range Iskander missiles in Kaliningrad, on Europe's border, and also install a radio-electronic device to scramble America's missile-defence system.

Alexander Golts, a Russian military analyst, says that this is the first time since the cold war that Russia has declared its intention to create a military threat to the West. Whether it can be backed by real military capabilities is another question. The timing of this threat looks particularly odd: even Soviet hawks used to wait for six months after an American election to make big statements of military strategy.

Having delivered his attacks on America, Mr Medvedev spent most of his 90-minute speech talking about Russian politics. His liberal-sounding language might have come from an opposition politician. He lashed out at excessive bureaucracy that yields nothing but corruption, and gave warning against state meddling in private business. Bureaucracy is guided by the same mistrust of free enterprise as 20 years ago, he said: it frightens business so that it doesn't do the wrong thing, controls the media so that they don't say the wrong thing and interferes in elections so that voters don't back the wrong person.

This last point was pretty hollow coming from a man who was hand-picked as president by his predecessor and patron, Vladimir Putin. Mr Medvedev also enjoyed the full might of Russia's bureaucratic and media machine on his way to the top job. Yet a mismatch between words and actions is a trademark of the Kremlin. It seems that it can adopt liberal or nationalist rhetoric with equal ease to push its message of strength and power.

Thus, Mr Medvedev went out of his way to pay respect to the constitution, only to propose a significant change: to extend the presidential term from four to six years, and the parliament's from four to five years. This was not originally Mr Medvedev's idea. Mr Putin first suggested it last year and he may also be the main beneficiary. The new rules will come into effect only at the next presidential election. If Mr Putin, widely seen as Russia's real boss, decides to return when Mr Medvedev's first term expires in 2012, he could then be looking at another 12 years in power.

The planned extension of the presidential term was accompanied by liberal gestures that would in practice make little difference to Russia's highly autocratic political system. Mr Medvedev said that the government should be made more accountable to parliament, for example. In reality, however, the Russian parliament was long ago turned into a rubber-stamping body dominated by Mr Putin's United Russia party. There is no longer any significant opposition to speak of.

One area Mr Medvedev did not talk enough about was the economy, even though this is what most Russians are now worried about. He warned state bureaucrats and law enforcers not to exploit the crisis to settle scores or grab assets. But he said little about how to unblock the banking system or tame public spending. Indeed, Mr Medvedev's main response to the financial crisis appears to be more anti-Americanism and moves to preserve the political system. This is unlikely to make Russia more democratic or prosperous.

Estonian spies

Fog in the Baltic

Nov 6th 2008 | TALLINN
From The Economist print edition

A sensational arrest inside Estonia’s defence ministry

FROM the published information, it hardly seems like a big deal. On September 21st Herman Simm, a middle-ranking civil servant in Estonia’s defence ministry, was arrested, along with his wife, and charged with spying for an unnamed foreign power. Mr Simm has made no public statement and his lawyer has not responded to requests for comment. Estonian officials flatly decline to discuss the case. But it is likely to come to court next year. If convicted, Mr Simm faces a jail term of between three and 15 years.

Some of the case’s details are startling. Mr Simm was already sidelined at the time of his arrest. But his previous job had been ultra-sensitive: he set up and ran the system for handling all classified information—including top-secret documents from Estonia’s NATO allies. He had been responsible for handling security clearances for Estonian officials in the military, security and intelligence services. A foreigner who is familiar with the case talks of “a potential European equivalent of Aldrich Ames” (once Russia’s top spy in America, who for years headed a CIA counter-intelligence department and is now serving a life sentence in jail). That could make this the worst NATO security breach to have happened for many years.

More intrigue surrounds the mysterious disappearance, at about the time of Mr Simm’s arrest, of a contact who is an Italian-employed Spaniard. This person is thought to have been an “illegal”: a Russian spy infiltrated into Europe via Latin America, using a carefully constructed false identity, and able to operate all round the European Union without suspicion. Such “illegals” are the crown jewels of foreign intelligence work: their bogus identities are complex and expensive to arrange, and they usually handle only a single source. But in what appears to have been a bad bit of espionage tradecraft by Russia’s foreign intelligence service, the SVR, this Spanish citizen contacted another highly placed source in a different NATO country and made slightly clumsy attempts to recruit him. The subject reported the encounter, setting in train the investigation that led to Mr Simm’s arrest.

A huge damage-control operation is now under way to work out what Mr Simm knew or had tried to find out. The security clearances he issued and denied, and any personnel moves resulting from them, are also under review. And security officials across Europe are busily checking the elusive Spaniard’s recent movements for other clues about clandestine activities. They are also following up the paper trail that brought him such an apparently convincing identity as an EU citizen.

The affair has raised many other questions. The Russian media are jeering that the Baltic states are not only Western stooges, but incompetent to boot. Yet the consensus in the world of shadows is not that new members of NATO such as Estonia are unreliable. On the contrary, Estonia’s intelligence and security services are well-regarded, which makes them a worthy target for foreign espionage. It was good counter-intelligence work that led to the arrest. And in most NATO countries, notes a seasoned Baltic-based spook, such scandals are usually hushed up, not prosecuted so gutsily.

Germany's Social Democrats

A mess in Hesse

Nov 6th 2008 | BERLIN
From The Economist print edition

The lessons from Andrea Ypsilanti's failure to form a coalition government

FOR Germans, it was billed as the second most thrilling vote on November 4th. Nine months after an election in Hesse had produced a tie between the two main parties, the state legislature was due to replace Roland Koch, boss of the local Christian Democratic Union (CDU), as premier and to install Andrea Ypsilanti, leader of the state's Social Democrats (SPD), in his place. The Greens and the Left Party had agreed to back her. All she needed were the votes of the 42 SPD deputies. But on the eve of her coronation, four of them rebelled. The consequences will be felt far beyond the state of Hesse.

The rebels' ringleader, Jürgen Walter, had lost a leadership fight to Ms Ypsilanti and was then passed over by her for the job of economy minister, so revenge may have been one motive. But weightier issues were also at stake. In proposing to form a minority government (in coalition with the Greens), Ms Ypsilanti was breaking an SPD campaign promise that it would not co-operate with the Left Party, the successor to East Germany's communists. Her plan was for the Left Party to prop up the government from outside, giving it a first taste of power in a western German state. That stirred "deep misgivings" in Carmen Everts, an SPD rebel who wrote her doctoral thesis on the PDS, forerunner of the Left Party.

The quartet also foresaw trouble for Hesse's economy. The 111-page coalition agreement between the SPD and the Greens promised to turn the state into a paradise for renewable energy—and a purgatory for coal and nuclear power. It also called for a review of a decision to allow night-time flights at Frankfurt's airport, which threatened to delay the building of a new runway. All this would cost jobs, Mr Walter claimed. News of the putative coalition's demise sent shares of Fraport, the airport's owner, up by 13%.

The SPD, the CDU's junior partner in Germany's grand coalition, has long agonised over how closely to work with the Left Party, which poaches its voters, and how far left it should lean itself. In February Kurt Beck, the SPD's then chairman, stunned his colleagues by giving Ms Ypsilanti's scheme his blessing. That contributed to his downfall in September. The debacle in Hesse will complicate and perhaps prevent co-operation in other states such as Saarland, home to the Left Party's populist chairman, Oskar Lafontaine, where an election is due in August.

Nationally, the SPD might eventually profit from the mess, says Hubert Kleinert, a political scientist at Hesse's University of Applied Sciences. The CDU would be denied the chance to exploit any alliance in Hesse with the Left Party to question the SPD's credibility in next year's federal election. The partnership would have been a constant source of friction. Its main glue was a shared desire to get rid of Mr Koch, who has hung on as caretaker premier ever since conducting a xenophobic (and unsuccessful) campaign for re-election.

Now the SPD and its friends may be stuck with him. His first move will be to try to forge a government from the present fragmented legislature, either with the Greens or the Free Democrats or, perhaps more likely, in a grand coalition with the humbled SPD. If none of these options succeeds, there will probably be a fresh election, which Mr Koch and the CDU could well win. The almost certain losers would be Ms Ypsilanti's SPD.

Fragile Bosnia

The break-up danger

Nov 6th 2008
From The Economist print edition

Growing fears that fractious political leaders are jeopardising Bosnia's future



BOSNIA'S leaders are "mired in the nationalist logic and talk of the past". The status quo is "unviable", yet no domestic forces can challenge it or influence the country's leaders "to replace their current disputes". Thus a new report to European Union foreign ministers by Olli Rehn, the EU enlargement commissioner, and Javier Solana, its foreign-policy supremo.

For two years, Bosnian Serb, Croat and Bosniak (Muslim) leaders have been bogged down in the same old quarrels that have dogged their country ever since the break-up of Yugoslavia in the early 1990s. They are now threatening to reverse many years of progress. Yet for 18 months, their bickering has been largely ignored by the EU, concerned more over the future of Kosovo and how best to stabilise Serbia.

No longer. Miroslav Lajcak, a Slovak diplomat who is in effect the international governor of Bosnia, has been touring the countries responsible for overseeing the Dayton peace accords that ended the war in Bosnia in 1995. He is demanding renewed attention to Bosnia, because he fears its self-serving leaders are bringing the country to its knees. A break-up of Bosnia would destabilise the whole region; at worst, it might reignite the Balkan wars.

The Bosnian war of 1992-95 ended, essentially, in a draw. Officially, the Bosnian Serbs gave up their quest to join Serbia, and Bosniaks gave up their dream of a unitary state. Instead Bosnia was split into a Bosniak-Croat federation and the Republika Srpska (RS). But Haris Silajdzic, the leading Bosniak politician, now condemns the RS as a "genocidal" creation that must be scrapped. And Milorad Dodik, the RS leader, threatens to secede unless it is left free to be run as a quasi-state.

Mr Lajcak wants EU foreign ministers to make clear to the Bosnians that they can hope to join the European club only if their leaders fulfil the pledges they have made so as to qualify—and also preserve their country's unity. Brussels, argue Mr Rehn and Mr Solana, has "unique leverage", which needs to be "reactivated in a more effective manner". They also say that, by the middle of 2009, the EU should take the lead in helping Bosnia to reform.

That will mean cajoling Bosnian leaders with a mix of carrots (eg, an easier visa regime) and sticks (eg, no further progress towards membership talks). But the new American administration may have different ideas, especially if its Balkan policy is dominated by officials who made their names there in the Clinton years. They may point critically to the fact that the EU's much-vaunted Kosovo mission is six months late getting up and running.

Bosnian politicians who attack Mr Lajcak may find themselves being subtly discredited. Most Bosnians just

want jobs and higher living standards. But they are frightened into voting for nationalists by leaders who use their positions to get rich. “We need to isolate these people from their electorate,” says one diplomat with lots of sordid details at his disposal. He may need to use them.

Transvestites in Turkey

Gender-benders

Nov 6th 2008 | ISTANBUL
From The Economist print edition

Transvestites test the limits of Turkey's tolerance

IN A cramped makeshift theatre in Istanbul, a Kurd in a purple dress titillates the audience with the story of how he was born a man but found he was a woman. During his act, Esmeray wields a sharp tongue to expose the systematic violence faced by fellow transvestites. "I am a Kurd, a transvestite and a feminist, so I am screwed all round," he says.

Human-rights groups say hundreds of transvestites are detained, beaten, tortured or sexually abused every year. Many are driven into prostitution. "They are seen as the lowest of the low and face more police brutality than any other group," says Eren Keskin, a human-rights lawyer. And when anyone has dared to file a complaint, she adds, "not a single policeman has been convicted."

Amberin Zaman



Esmeray in the purple

Turkey is said to have more transvestites per head than anywhere bar Brazil. Fascination with cross-dressing dates to Ottoman times, when winsome boys dressed as girls would belly-dance for the sultan. But, just as tolerance of Christians and Kurds withered under Ataturk's republic, so it did for transvestites and gays. The success of a few transvestite singers disguises the "general acceptance in Turkish society that we are freaks," says Funda, a transvestite dancer.

Same-sex relations are not banned in Turkey. But like America, it bans gays and cross-dressing men from the army. Yet to win exemption from mandatory military service, they must prove their sexual orientation. A Human Rights Watch report notes that this can involve "abusive and intrusive anal examinations", and adds that many are forced into psychiatric treatment because they are deemed to be mentally ill.

Such abuses have drawn rebukes from the European Union. Emboldened by EU-inspired reforms, gays are starting to speak up. In June Istanbul hosted the country's biggest gay pride parade, with hundreds of unfazed riot police looking on. The parade featured veiled transvestites protesting against the ban on Islamic-style headscarves at universities. A vocal band of pious women is now fighting discrimination against cross-dressing compatriots. This alliance is just one example of Turkey's unusual mix of Islam and democracy.

The government is not so liberal. The interior ministry is said to be behind efforts to disband Lambda, an advocacy outfit, because it is sowing immoral values. An Istanbul court has ruled against Lambda, which is now appealing. And Esmeray is battling against two policemen who allegedly punched and kicked him as he was walking home in June 2007. The men are to appear in court next March on charges of causing him bodily harm. "Justice is slow, but it will come," he vows.

Charlemagne

Russian lessons

Nov 6th 2008
From The Economist print edition

Europe quietly caves in to agree to new partnership talks with Russia

Illustration by Peter Schrank



THE European Union is finding itself in unfamiliar territory with Russia. Its trouble stems, unusually, from having been too clear and overly united in its demands towards its eastern neighbour. This dates from just after the August war in Georgia, when the Europeans were desperate to press Russia to remove its tanks and men from the country. The leaders of all 27 EU countries met at an emergency summit on September 1st, and—breaking with their normal habits of mudge and fudge—issued an admirably limpid demand, backed by a crystal-clear condition.

The leaders issued the following declaration, in writing: until all troops withdrew to positions they held prior to August 7th, the day before the war began, the EU would suspend any negotiations on a new partnership and co-operation agreement (PCA) with Russia. It was hardly a savage threat: such pacts are bureaucratic rather than historic, offering a single legal framework for matters that range from border disputes to squabbles over salami imports. Moreover, Russia cares about a new PCA less than the EU does. Two-thirds of its exports to Europe involve gas, oil and minerals, which bring in cash even without strong rules.

But Europe's threat was clear. And that, two months later, has led to a painful moment. Most EU governments now want to resume talks on a new PCA with Russia—foreign ministers are expected to agree this at a meeting on November 10th, just in time to cast a cheering glow over an EU-Russia summit in Nice four days later. But Russia has not pulled all its troops back to pre-conflict positions. For all the "angels on the head of a pin" obfuscation offered by Russian envoys, Europe's demand has clearly not been met, as one EU diplomat concedes. At a minimum, there are Russian (and Russian-backed) forces in such places as Akhalgori and the Kodori gorge that Georgia controlled before the war.

If you believe the hype that the EU works differently from grubby nation-states, this ought to matter. The EU, its supporters sometimes claim, offers a model of how 21st-century diplomacy should be conducted. It is a multipolar alliance in which relations between big and small countries are defined by binding rules. The union itself is a happy hybrid: a political sort-of-government and an almost-judicial regulator, built on a bedrock of almost 100,000 pages of legislation. Europe, they say, may not do the "hard power" of military force, but it wields lots of "soft power". Its order, wealth and stability attract its closest neighbours (who all want to join one day) and can even weave such mighty powers as Russia and China into a web of legal agreements.

Here and now, however, the EU is faced with a less high-falutin' problem. Its highest political body—a summit of 27 heads of state and government—set a condition for Russia that has not been met. Do they

now pretend that it has been? Individual countries are capable of such realpolitik. But that would be "disastrous" for the EU, says one foreign minister (whose country is bracing itself, glumly, to endorse a resumption of talks on a new PCA with Russia). Europe's relations with Russia must be as rules-based as possible, he says. "When we see them violating rules, we should be very clear in our language."

Yet even that modest demand is not a done deal. On November 10th some countries, such as Britain and Sweden, would like to use language acknowledging the gravity of the moment: perhaps a statement that the EU's relations with Russia were marked durably by the conflict with Georgia. But others, including Germany, France and Italy, see no reason to "dramatise the restart of negotiations" at all, says a diplomat.

All manner of excuses are now in circulation as to why talks on the PCA should be resumed. Postponing a new agreement would mostly hurt Europe, goes the most common argument. But postponing talks was the condition that Europe chose to set, after much behind-the-scenes muddle. (Early drafts of September's summit conclusions were soft, it is said, because everybody expected Silvio Berlusconi of Italy, a cheerleader for unconditional friendship with Russia, to block anything tough.) After some swift haggling, leaders finally fixed on postponing the PCA talks. And in a sense, what they chose is beside the point: the EU leaders could merely have threatened to leave the Kremlin off their Christmas-card lists, say. The real test lies in what follows from Russian non-compliance.

Some officials urge their critics to focus on Europe's broader success in ending the conflict in Georgia. Using "soft power" alone, they say, EU mediators, led by President Nicolas Sarkozy of France, stopped Russian troops from rolling into the Georgian capital and toppling the government of Mikheil Saakashvili. Nobody else could have done more, it is argued. But it is not clear that the EU stopped the Russians; and the reason Europe did not try to do any more is mainly that EU unity would not have held.

Unity in jelly

At the least, such arguments reveal something important: that the hype about the EU's soft diplomacy is not believed by those who practise it. One diplomat involved in the Russia dispute draws a distinction between life inside and outside the union. Within the EU, relations are shaped by the rule of law, with judges ready to enforce strong principles of human rights or competition policy. Outside, he says, Europeans "live in a Hobbesian world", where the "balance of power" dominates.

Europe's main strength in foreign policy is not its commitment to a rules-based multilateralism, adds another official. Europe's strength is its unity—hence the need to come up with a quick decision to resume the talks with Russia, to "keep the sheep in the pen", and stop individual countries "going off on their own". In short, the EU's unity over Russia in September was quite unsustainable. And in the interests of preserving long-term unity (Europe's strength), the EU will now back down, in unison. At least, the world will then look more familiar.

Gauging the recession

How deep and how long?

Nov 6th 2008
From The Economist print edition

Interest rates will fall even more as fears of a severe recession mount

EPA



EXTRAORDINARY times prompt extraordinary measures. Since the Bank of England was freed to set interest rates in 1997, the most it has ever cut them in a single month was half a percentage point, most recently on October 8th. But on November 6th the central bank went several steps farther and slashed the base rate by an astonishing one-and-a-half percentage points, bringing it down from 4.5% to 3%, the lowest since early 1955.

Just as extraordinary, there will almost certainly be more monetary easing in the months ahead as the central bank grapples with the credit crisis and tugs the base rate still lower in order to get some reduction in banks' lending rates. Some economists have been predicting that it will fall to 2% next year, winding the clock back to 1951. If it declines still farther, as others are calling for, that would rewrite British monetary history. Never since the Bank of England was created in 1694 has the base rate been lower than 2%.

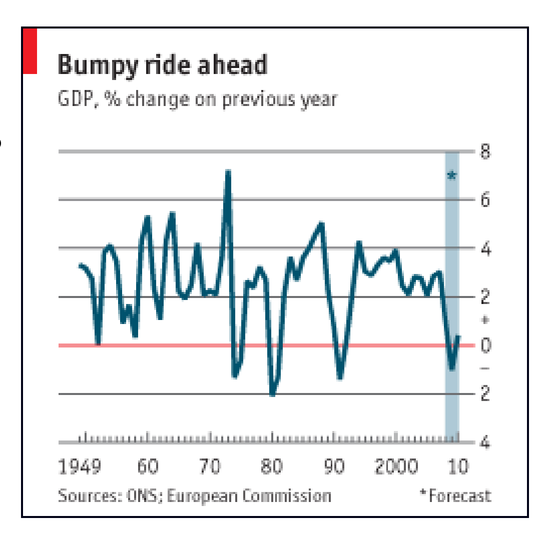
Formally, the outlook for inflation will determine the course of interest rates, as the central bank's monetary-policy committee (MPC) seeks to meet the inflation target of 2% a year. Even though consumer prices rose by 5.2% in the 12 months to September, the highest rate since March 1992, inflation looks set to tumble over the next year, helped by the collapse in oil prices. In an astonishingly swift turnaround, the MPC has started to fret that inflation may fall too far below the target rather than stay embarrassingly above it.

The shift reflects fears about the severity of the recession now under way. The decline of 0.5% in GDP in the third quarter compared with the second was a lot sharper than expected. And business surveys are indicating that the final quarter of 2008 has got off to a dismal start. Manufacturing conditions in October stayed close to the previous month's record low, and activity in construction and services plumbed new depths, according to this week's purchasing managers' reports. Together, these findings suggest that the decline in GDP in the fourth quarter will be at least as steep as in the third, says Vicky Redwood of Capital Economics, a consultancy.

The outlook for next year has been getting bleaker and bleaker as forecasters seem to vie with one another to produce the most pessimistic projection. In early October the IMF predicted that GDP would fall by 0.1% in 2009. This week, by contrast, the European Commission said it would decline next year by

1%, the biggest drop among the 15 old states of the EU.

After almost 16 years of continuous expansion, which ended in the second quarter of 2008 when GDP stalled, a full-year decline of 1% will hurt. But provided the economy starts to grow again in 2010 (even if only by the 0.4% that the commission expects), the setback will be less serious than the previous recession, when GDP fell by 1.4% in 1991 (see chart). And it would be considerably less painful than earlier recessions, in the mid-1970s and early 1980s, during both of which GDP fell in two successive years. The commission is also predicting a fairly soft landing for the labour market, with the jobless rate rising from 5.7% to 7.1% in 2009. By contrast, it reached nearly 11% in the early 1990s.



All three previous recessions came after housing booms and oil shocks—a characteristic that they share to some extent with the current one. But recent experience has been markedly different in one crucial respect. Although this year's rise in inflation was shocking, even at its recent peak it was far lower than in earlier episodes, especially those of the mid-1970s (when inflation almost hit 27%) and the early 1980s. Wage inflation has remained tame, preventing the upward spiral of pay and prices that wreaked such harm on previous occasions. One reason is that the economy has been spared the wild GDP boom that preceded the downturns of the mid-1970s and early 1990s.

That supports forecasts that this downturn will be less grave than previous recessions. In contrast with those episodes, the central bank does not now have to counter a home-grown inflationary spiral. The impending fall in inflation, assuming that oil prices do not bounce back again, will do much to help households after the battering their living standards have taken over the past year.

Yet there are still grounds to think that this recession could match previous ones. Credit difficulties contributed to earlier downturns. A retrenchment in bank lending to companies exacerbated the recession of the early 1990s, and there was a serious, if largely hidden, banking crisis in the mid-1970s. But the credit squeeze now in train following the recent banking panic is of a different order of magnitude.

That is why some economists reckon the recession is likely to be grave rather than mild. Capital Economics, for example, is now predicting that GDP will decline by 1.5% next year and then by 1% in 2010, making the recession the worst since the early 1980s. It also fears that the jobless rate will reach 10.5% in 2010, virtually as high as its peak in the early 1990s.

Such forecasts may seem gloomy, but the experience of other countries that have had big banking crises suggests grounds for pessimism. Output losses following such mishaps are often large, according to a recent study by Luc Laeven and Fabian Valencia, economists at the IMF. Sweden, which ran into trouble in the early 1990s, suffered three years in which GDP shrank at an average rate of almost 1.5%.

Dramatically looser monetary policy, together with some fiscal easing, can help to mitigate the severity of the downturn now under way. But even with such support, the evidence suggests that Britain's first recession for almost two decades is likely to be deep and long rather than shallow and short.

Heathrow

Third-runway blues

Nov 6th 2008
From The Economist print edition

The case for expanding the world's busiest airport gets weaker by the day

AFP



No room to grow here

LIKE so many of the flights that leave Heathrow, the government's decision on whether to allow the airport to have a third runway is running late. BAA, the airport's operator, had expected to get the green light in July. The announcement is now promised before the end of the year. The prime minister prides himself on his ability to take "tough, long-term decisions", but a rising number of Labour MPs and several senior ministers think he is in danger of taking the wrong one on this issue.

The arguments for and against expanding Heathrow have polarised opinion ever since the government declared in its 2003 aviation white paper that giving the overcrowded old airport another runway was its preferred way of meeting the expected growth in passenger numbers. Some ministers were nervous about antagonising both climate-change pressure groups and the long-suffering residents of west London who bear the brunt of the aircraft noise and air pollution that Heathrow generates. But skilful lobbying by BAA and British Airways (BA), two formerly state-owned companies with close links to government, appeared to have settled the issue in late 2006. A bigger Heathrow that could compete for international transfer passengers with rival hub airports on the continent was deemed a national economic necessity.

Mr Brown, always eager to distance New Labour from old Labour's hostility to business, is susceptible to such arguments, even when there is little evidence to support them. But a series of developments this year have left them looking weaker than ever.

The first blow was the botched opening of Terminal 5. Although the incompetence of BAA and BA, witheringly exposed in a parliamentary report this week, has little direct bearing on the third runway, the two companies leading the campaign for it became a national embarrassment.

The second was the publication in August of the findings of the Competition Commission's inquiry into the effects of BAA's near-monopoly of airport ownership, especially around London. The commission said it was likely early next year to order BAA to sell two of its three airports serving London. BAA quickly put Gatwick, the second most important, up for sale.

The commission made it clear that the government needed to respond as well, by reviewing the flawed conclusions of the 2003 white paper and the entire system of airport regulation. Whereas BAA has had no incentive to develop Gatwick as a rival to Heathrow, any new owner will see things differently. Expanding Gatwick is not without difficulties, but these are trivial compared with those at Heathrow.

The third blow is the impact on air travel of seesawing fuel prices, dwindling credit and economic recession. Thirty airlines have gone bust this year and Willie Walsh, BA's chief executive, expects another 30 to follow them. Survivors are cutting capacity and raising prices. The number of flights to and from Heathrow this winter is forecast to fall by 2%. Mr Walsh believes the era of cheap flying, which has propelled the rapid growth of recent years, is over.

The credit crunch will affect BAA too, in at least a couple of respects: it will cut the price Gatwick will fetch and make it much harder for the debt-laden airport operator to finance the future development of Heathrow. It may be years before investors are again willing to back big private-sector infrastructure projects.

Environmental concerns will also hinder passenger growth. Last month the European Union confirmed plans to bring airlines into its emissions-trading scheme in 2012. Travellers will bear the cost through

dearer tickets. A fortnight earlier the British government announced plans to cut CO_2 emissions by 80% from their 1990 levels by 2050. Many (including some Labour MPs) think that sits uneasily with increasing the size of Heathrow.

The Tories certainly reckon so and have declared their opposition to a third runway on environmental grounds, favouring new high-speed rail links as an alternative to domestic flights. Given the likelihood of a Conservative government after 2010, the plan for a bigger Heathrow is probably doomed. But Mr Brown, eager to contrast his willingness to take those difficult decisions to safeguard the nation's prosperity with what he will portray as Tory frivolity, seems determined to plough on. It is likely to be an increasingly lonely furrow.

Banks and capital

Reshaping the landscape

Nov 6th 2008
From The Economist print edition

There is undesirable stuff on both sides of the balance-sheet

YOU'VE heard of toxic assets; now say hallo to toxic liabilities. These are the government-sponsored shares that some British banks are turning to in order to meet the new, more stringent, capital requirements of the Financial Services Authority (FSA), a financial watchdog. Over the next month or two, the Royal Bank of Scotland (RBS), Lloyds TSB and HBOS, three of the country's five biggest banks, plan to issue new ordinary shares, underwritten by the government, and to sell the government preference shares that come with strings attached: no dividends, a limit on bonuses for staff and pressure to keep the loans flowing to homeowners and small businesses.

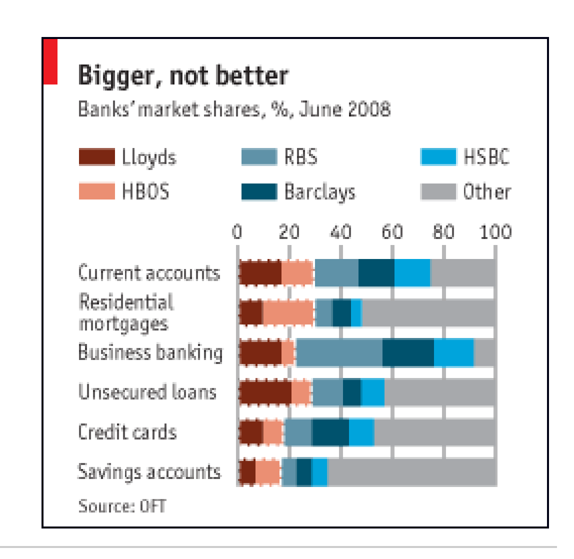
Existing shareholders are not amused. Those at Barclays, another of the big five, are possibly even more irate. Barclays plans to raise £7.3 billion ($11.6 billion), £5.8 billion of it from Qatar and Abu Dhabi. But spurning the government's open hand (and the interference bankers think may come with it) will cost the bank as much as £3.2 billion, according to analysts. Neither scenario is likely to instil loyalty in current owners, who have already seen the banks' share prices plunge by 60-90% over the past year, and will now see their holdings diluted to boot.

On November 20th RBS's shareholders will vote on its plan to raise £20 billion in capital. Given the sorry outlook for earnings this year they have little choice but to go along. Lloyds TSB's shareholders will decide on November 19th whether to accept both new government-underwritten capital totalling £5.5 billion and a proposed merger with HBOS. Despite concerns raised by the Office of Fair Trading (OFT), the government decided on October 31st not to refer the merger to the Competition Commission, putting financial stability above consumers' interests. If Lloyds TSB's owners approve the merger, HBOS shareholders will vote on it in early December.

The emerging banking system looks likely to be inhospitable to businesses and consumers alike. A new government agency, UK Financial Investments, is to manage the state shareholdings in RBS and Lloyds/HBOS, as well as Northern Rock, a mortgage bank nationalised in February, and the assets rescued from Bradford & Bingley in September. It will do so "at arm's length", says the government soothingly. But will it be able to represent the interests of the taxpayer as shareholder, which means maximising returns, while urging banks to fight recession by continuing to lend to homebuyers and small businesses?

Banks issuing preference shares—which pay interest of 12% a year—will want to redeem them as soon as possible and be free of conditions that could prove irksome. Such alacrity may please the FSA, but "we're not going to stand by and see them gouge their customers," says one official. "We are concerned about a weakening of competition, not immediately, but in the next two or three years," says John Holmes at Which?, a consumer watchdog.

Others worry that the way the banking landscape is being reshaped sends the wrong signals to investors and other merger candidates, even to foreign governments, about competition policy in Britain. The merger of Lloyds and HBOS, agreed in a hurry in September before the government launched a broad bail-out scheme, now looks unnecessary, and it will reinforce the dominance of a few players in retail and small-business banking (see chart). A rethink is unlikely, although Jim Spowart, a Scottish entrepreneur and former HBOS employee, says a counter-bid for HBOS is in the works. Legislation rushed through to smooth the deal's path adds "financial stability" to the sorts of "national security" that may be invoked in ruling on mergers. A bad precedent.


Bigger, not better
Banks' market shares, %, June 2008
Lloyds
RBS
HSBC
HBOS
Barclays
Other
0
20
40
60
80
100
Current accounts
Residential mortgages
Business banking
Unsecured loans
Credit cards
Savings accounts
Source: OFT

Trump's Scottish venture

Birdie or bogey?

Nov 6th 2008 | ABERDEEN
From The Economist print edition

The controversial golf development may not make much money

AMERICA'S most flamboyant property tycoon, Donald Trump, is no lover of government. Burons, which he defined as a cross between a bureaucrat and a moron, are destroyers of opportunity, he wrote in 2000. This week he had to give thanks to Scottish burons for hauling his plan to spend £1 billion ($1.6 billion) on a lavish golf resort near Aberdeen out of the bunker into which local councillors had pitched it. He may have landed in the thick rough of recession instead.

The strip of scrubby, marshy land on which Mr Trump wants, with typical understatement, to plant the world's finest golf course, a 450-bedroom hotel and conference centre, 950 holiday apartments, 36 golf villas, 500 houses and sundry other developments, doesn't look much. With face-slappingly bracing autumnal winds whipping in off the North Sea, it doesn't feel inviting either.

The most notable feature, which caught Mr Trump's entrepreneurial eye, is a line of rearing sand dunes sheltering the countryside from the crashing sea beyond. Parts of these constantly shifting dunes, which Mr Trump expects will provide spectacular golf, are deemed worthy of protection because they provide an unusual habitat for plants and wildlife. But the rigours of golf demand that the dunes be rendered immobile. A year ago, that persuaded local councillors to rule Mr Trump out of bounds.

Appalled at their shortness of vision, Alex Salmond, Scotland's first minister and a keen golfer, ordered a public inquiry. To the ire of conservationists, it held that the project's "significant economic and social benefits" (4,700 construction jobs and 1,400 permanent posts) mattered more. On November 3rd Scottish ministers told Mr Trump to implement such things as a "goose-management scheme", but approved the plan.

Earning a profit on this, however, may be harder than getting round the course in par. Recovering the investment depends on selling the houses. This autumn, after five years of steadily rising, Aberdeen house prices suddenly dropped by 7% and sales volumes halved. And this week oil prices fell below $60 a barrel, threatening to hurt the offshore-oil industry.

Golf is no longer a sure-fire winner either. The American owner of the ultra-posh Loch Lomond club, which counts Prince Andrew as a member and hosts the Scottish Open, is having to sell it to repay loans. Plans by another American property mogul, David Wasserman, to convert a St Andrews student residence into pricey apartments in the most desirable location in golf—hard by the 18th green of the venerable Old Course—seem to have come to grief. Playing golf in Scotland can be tough, but making money out of it is a whole lot tougher.

Funding health care

Mix and match

Nov 6th 2008
From The Economist print edition

An injection of pragmatism keeps an ageing NHS on its feet

IN MANY countries, payments by patients provide the lubricant that stops taxpayer-funded health systems from grinding to a halt as their users grow older, fatter and less fit, and a constant stream of pricey new drugs are released to treat the lifestyle diseases that result. But not in Britain, where a literal interpretation of the rules of the National Health Service (NHS)—that treatment be available for all equally, irrespective of ability to pay—has threatened to bring it crashing down. The point at issue has been whether patients who buy treatments that the NHS will not provide should be deemed to have opted out of the system altogether, and made to pay for all their care. Allowing "co-payments", the health secretary, Alan Johnson, told Parliament last year, risked overturning the NHS's founding principles.

That would be serious: the NHS has justly been described as the nearest thing Britons have to a religion, and politicians who tamper with it risk charges of heresy. But the sight of terminally ill cancer patients being turned away by the NHS for having the temerity to buy life-extending drugs the state refuses to pay for threatened to cause mass apostasy. So in June Mr Johnson asked Mike Richards, a professor of oncology who oversees NHS cancer treatment, to look again at the policy. His recommendations, published on November 4th, provided the absolution the health secretary needed to perform a U-turn.

Among the words people used to describe to Mr Richards the withdrawal of NHS care from patients who "topped up" were "despicable", "spiteful", "perverse" and "inhuman". The policy has duly been abandoned, with two attempts to placate fundamentalists. The first is a figleaf: care paid for privately by patients who are simultaneously being treated on the NHS must be administered away from NHS facilities, the thinking apparently being that those who cannot afford to top up will mind less if they can't see others getting what they are not. The second, more substantive, proposal is to reduce the need for top-ups in the first place.

The National Institute for Health and Clinical Excellence (NICE), which rules on whether treatments offer sufficient health benefits for the money they cost, has been told to act more quickly, so that fewer patients miss out on treatments that have come to market but not yet been evaluated by NICE. It is also to be more generous in assessing end-of-life treatments, and those for rare diseases. The general public, said Mr Richards, thought NICE had been undervaluing the chance of an extra few months for the terminally ill. And patients with rare diseases were getting a raw deal because NICE was rejecting specialised drugs that are inevitably pricier than those that serve a larger market.

Health-care managers in other countries sometimes wonder if NICE is worth copying. After all, the justifications for its existence—to get value for money and to clamp down on health-care costs—are goals that are hardly unique to Britain. And its approach—assessing treatments and rejecting those that cost more than a certain amount per quality-adjusted life-year (QALY; an extra year of life, discounted for pain, disability or other impairments)—is appealingly logical and transparent.

And therein, perhaps, lies the reason why so far none have. Studies suggest that NICE is more generous than much of the rest of the NHS: one analysis found that the managers who control local health-service budgets tend to be willing to spend only around £12,000 to gain an extra QALY for patients with circulatory disease, compared with the £30,000 NICE generally allows for drugs. Yet when NICE turns down a treatment it is roasted by the press for penny-pinching. The reason, presumably, is that NICE makes its decisions in public and uniformly, rather than ad hoc and behind closed doors—and the average citizen, who tends to be less cold-heartedly rational than the average health-care wonk, looks to his religion for comfort as well as for salvation.

Nuclear power

Limits to growth

Nov 6th 2008
From The Economist print edition

A new generation of nuclear plants requires a new generation of nuclear physicists

MUCH more than worries about safety, the biggest obstacle to the revival of nuclear power in Britain is cost. Atom-splitting is expensive, with brochure prices for reactors starting around £3 billion, and dizzying lurches in oil prices make it hard to evaluate the industry's competitiveness. "Nuclear power works for oil prices above $60 a barrel," said a government adviser confidently in early October, when it was still near $100. As *The Economist* went to press, the price of oil was hovering around $64, barely above that margin of safety.

But even if financial worries can be overcome, there are other obstacles to a nuclear renaissance. Among them is a global shortage of manufacturing capacity for important components: only one Japanese firm is currently capable of making reactor pressure vessels, for instance. And this once-in-a-generation overhaul of the electricity grid is not the only grand engineering scheme in the works in Britain. Crossrail (a link through London), the 2012 Olympic games, an enormous housing development in London's Thames Gateway and the dismantling of old nuclear reactors will all absorb welders, joiners, engineers and raw materials, pushing up costs and leaving less for new nuclear plants.

The biggest problem, though, is a shortage of qualified scientists, engineers and technicians. Nuclear power's long unpopularity has left the industry depleted, and many of those who remain are greybeards. Cogent, an industry training body, reckons that between a fifth and a third of nuclear workers will retire in the next decade, just when their knowledge will be in greatest demand. The government forecasts that up to 1,500 workers need to be replaced every year merely to maintain the status quo. Decommissioning old reactors and building new ones will require 18,000 more over the next 20 years.

Much thought has been expended on filling the gap. On November 4th the Nuclear Decommissioning Authority (NDA), the office charged with shutting down and cleaning up Britain's ancient first-generation reactors, launched a training drive, promising to create a national nuclear laboratory and promote careers in nuclear physics for youngsters. Ministers have set up a "National Skills Academy for Nuclear", which offers foundation degrees and lower-level vocational qualifications.

They are particularly keen on turning out academic engineers and physicists with specialised masters' degrees. That could be difficult, however. Physics teaching is in a parlous state, says Peter Main of the Institute of Physics, with only around 3,000 undergraduate physicists getting degrees each year and a severe shortage of specialised teachers in schools. In the past many physics graduates have vanished into the City, attracted by sky-high salaries in finance. That may change: the NDA estimates that it will spend around £74 billion over 130 years, and there is keen corporate interest in new reactors too—which suggests that careers in nuclear power will become more lucrative. Birmingham University, which offers a master's degree in reactor physics, has seen applications treble in the past three years, and other universities have started offering similar courses. British Energy, a nuclear-plant operator, says more graduates are applying for jobs too: it now gets 45 applicants for each position.

Yet Mr Main is wary of market signals. "Students do not often realistically research their career prospects," he says, and frets that some could be put off by the nuclear industry's tainted reputation. Even that, though, could change. Nuclear power splits green opinion like nothing else, and although groups such as Greenpeace remain opposed, iconic environmentalists including James Lovelock and Patrick Moore (one of Greenpeace's founders) have come out in support of atom-splitting as the solution to a warming planet.



WORLD
BRITAIN

Paying for the BBC

Broadcasting uncertainty

Nov 6th 2008
From The Economist print edition

Renewed questions about the future of the television licence

TO THINK it was once nicknamed “Auntie”. Fraudulent phone-in competitions and profane Christmas shows have sullied the reputation of the British Broadcasting Corporation (BBC) for high-minded paternalism in recent years. Worryingly for the corporation, the latest scandal—a crude prank phone-call by two of its stars broadcast on radio—has done more than provoke complaints of poor taste (though there have been more than 30,000 of those). It has also revived a bigger political debate about the BBC’s future.

On November 3rd David Cameron, the Conservative Party leader, deplored the vast salaries paid to senior staff by an organisation that is funded by a £140-per-household licence fee. Andy Burnham, the culture secretary, is thought to feel the same way. Mr Cameron also urged the BBC to curtail its involvement in sectors such as publishing to avoid crowding out private firms, and suggested that it be regulated by an independent body.

Support for the BBC is traditional among the political classes, notwithstanding Tory grumbles about its perceived left-wing editorial slant. But the television licence (without which a household cannot legally watch the box) is seen by some as anachronistic in an age in which viewers can flick among myriad commercial channels and watching programmes online is fast becoming common. The government granted a lower-than-expected increase in the licence fee in 2007. And both Labour and the Tories have flirted with the idea of using some of it to support the public-service output of other broadcasters.

The latest row is piffling compared with the messy showdown between Labour and the BBC after the Iraq war, which ultimately forced the resignation of the corporation’s director-general, Greg Dyke. Mr Burnham professes to be a friend of the BBC, as does Jeremy Hunt, his Tory opposite number, whose hawkishness on the licence fee goes no farther than tentatively suggesting that money left over from the imminent conversion to digital broadcasting be given back to households.

But pressure for a more radical review of the BBC’s funding may yet grow. Support for the licence fee varies from poll to poll, but is never overwhelming: only 22% approve of it, according to one published on November 2nd; 41% according to another, in August. An ICM survey for the BBC itself in 2004 found more than two-thirds of the public wanted the fee replaced by subscription or advertising. Such begrudging may become more common as the recession bites and more households struggle to pay what is in essence a regressive tax.

A further threat may emerge from one of the BBC’s own innovations. iPlayer, which allows TV programmes to be watched via the internet without a licence, is proving hugely popular: internet service providers groan about the traffic it has generated since its launch last year. There is little immediate prospect that it could undermine the BBC’s traditional funding stream, as the number of households that shell out for broadband but not for a television licence is small. And live television (which requires a licence to watch even on the internet) remains a big draw, especially for sporting events. Even so, the BBC has said that it will ask the government to bring the iPlayer under the umbrella of the licence fee if these circumstances change.

And change is likely, if not imminent. The iPlayer has served the original function of the BBC: to invest in ventures deemed too risky by the private sector. Its enormous success may hasten other broadcasters’ expansion of their own on-demand internet programming. Even Mr Dyke has said that the licence fee is unlikely to survive this trend. A rethinking of the television licence would be inevitable in a world without television sets.

Bagehot

No, you can't

Nov 6th 2008
From The Economist print edition

What Barack Obama does—and doesn't—mean for British politics

Illustration by Steve O'Brien



IF FURTHER proof were needed of the different rhythms of British and American politics, it came during prime minister's questions (PMQs) in the House of Commons on November 5th. Gordon Brown and David Cameron, the leader of the Conservatives, were competing to extol Barack Obama's victory. Amid the sycophantic paeans, the speaker of the house rose—to reprimand Mr Cameron for his improper use of the second person.

The Battle of Obama is joined. Mr Brown and Mr Cameron, Labour and the Tories, are wrestling for the reflective boost that association with Mr Obama in the public mind could bring. Neither is likely to succeed.

First, consider the hope the Tories spy in Mr Obama's hopemongering. (Many top Tories rooted for him, despite Mr Cameron's public chumminess with John McCain.) It rests on a simple syllogism: Mr Obama offered change and Mr Cameron purports to; despite his lack of executive experience, Mr Obama won—so Mr Cameron is more likely to. At PMQs, Mr Cameron flung Mr Brown's taunt—"This is no time for a novice"—back at him, asking if that had been his congratulatory message to Mr Obama. If the new president handles the economy competently, the Tories will use him to argue that crises are best solved by fresh thinkers.

It is true that British voters are angry, disenchanted and bored with the Labour government—as Mr Brown's early and silly efforts to portray himself as "the change" implicitly acknowledged. Obamamania, and the strange intimacy and chemistry of politics in a globalised world, may reinforce Britain's hardening yen for novelty. All the same, the Tories' syllogism is flawed. It mistakenly presumes that any kind of change will do.

Mr Cameron's team can point to some superficial likenesses between their man and Mr Obama. Both are calm under pressure, youngish and astutely opportunistic. Mr Cameron is a decent orator, if not quite an Obaman one. But in other ways their stories diverge. Mr Obama is the son of a one-time Kenyan goatherd, and grew up in Hawaii and Indonesia. Mr Cameron is the son of a stockbroker, and was raised in a handsome pile in Berkshire and at Eton. Mr Obama began his political career as a community organiser in the south side of Chicago; Mr Cameron went straight from Oxford to the Conservative

research department.

More important, perhaps, is the contrast between their pitches. Mr Obama pledges to heal primeval rifts and repair the reputational damage done by a war he opposed. Mr Cameron is avowedly sceptical of grand plans. He often lurches from optimism into bitter moralising; his party supported the invasion of Iraq. His biggest problem has been to overcome toxic memories of previous Tory governments; Mr Obama's has been to construct a public identity from scratch. Their political projects are radically dissimilar. Few Britons watching Mr Obama will instinctively think, fondly or otherwise, of Mr Cameron.

But nor is Mr Brown's effort to co-opt Mr Obama likely to flourish. His counter-claim at PMQs was that he and Mr Obama share the same "progressive values", and the same faith in government initiatives such as fiscal stimuli. He implied that the American people had endorsed what is now his main contention: that parties of the centre-left are best qualified to cope with the downturn. America has morphed in his rhetoric from the source of economic evil to the fount of political wisdom.

The trouble with this analogy is not just that Mr Brown is a droning killjoy and Mr Obama is not. It is that Mr Brown is an incumbent where Mr Obama is an insurgent. Mr Brown has been at the apex of government through the years that incubated the economic woe. Few Britons listening to Mr Obama's rhetoric will feel it vindicates their incriminated prime minister.

A subsidiary Brownite hope is that Mr Obama's accession will somehow bolster their man's international standing. Yet even though he shares some of Mr Brown's convictions and emphases, Mr Obama is more likely to diminish than enhance the prime minister's profile. The prominence Mr Brown achieved in the global financial crisis has already been threatened by Nicolas Sarkozy's hyperactivity; he will soon be eclipsed altogether by the president-elect. Nor would it be surprising if, when Mr Obama takes office, cultivating Mr Sarkozy is a higher priority than brainstorming about the IMF with Mr Brown.

If Mr Obama resembles anyone in recent British history, it is Tony Blair, another leader from everywhere and nowhere, who synthesised charisma, optimism and gushy rhetoric without causing too much alarm. The sad truth for Mr Cameron and Mr Brown is that—like Harold Macmillan with JFK—alongside Mr Obama they will both look depressingly plain.

The Obama effect

That is not to deny that Mr Obama's victory has huge implications for Britain. Most obviously, withdrawing Britain's remaining troops in Iraq—without inflicting collateral damage on the "special relationship"—will be easier. On the other hand, an Obama presidency will help to keep British forces in Afghanistan, perhaps in greater numbers (even if Mr Obama manages to inveigle other Europeans into making greater commitments there). In Britain, as in other countries, he may provide some remote therapy for race relations. Britain's racial history is unlike America's, as is its demography. But some of its problems—such as alienation and low self-esteem among some minorities—are similar. Mr Obama's omnipresent visage may help.

And the election will have some political fallout. There will be more interest in primary-style ballots to select parliamentary candidates. It will be tough for Mr Brown to avoid debating with Mr Cameron on television. The main parties will overhaul their primitive use of the internet and their tactics for recruiting young supporters. But the outcome of the leaders' bids to capture some of Mr Obama's lustre will probably be: no, you can't.

Cities and growth

Lump together and like it

Nov 6th 2008
From The Economist print edition

The problems—and benefits—of urbanisation on a vast scale

Panos



IN JANUARY this year a vast number of would-be travellers were stranded at railway stations and on roads in China, after an unusually heavy snowfall blanketed the south of the country just before the country's new-year festivities. What amazed the world (in addition to the unusual sight of a prime minister apologising for his government's slowness) was the unprecedented scale of the disruption: an estimated 200m people were on the move.

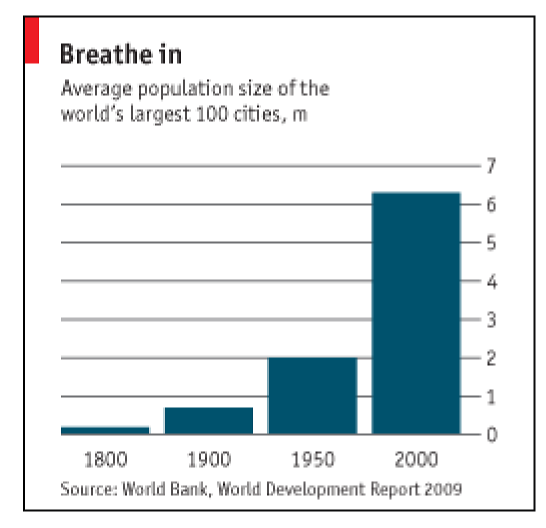
Governments in many poor countries react with a shudder to this sort of news item—and indeed to any news that seems to expose the fragility of newly urbanised economies. Most of those frustrated Chinese travellers were migrant workers going from cities to their families in the countryside or vice versa. Movement on such a scale seems inevitable, given the sort of urbanisation China and others have experienced: over the past 30 years, the world's urban population has risen from 1.6 billion to 3.3 billion, and over the next 30 years cities in the developing world are set to grow by an extra 2 billion. But many governments have become doubtful of their ability to cope with urbanisation on such an enormous scale; some have concluded that they ought to slow the process down in order to minimise social upheaval. This view owes as much to anti-urban bias as it does to sober analysis.

In 2005, more than half the poor countries surveyed by the UN Population Division said they wanted to reduce internal migration to rein in urban growth. The food crisis of the past 18 months has sharpened worries about how to feed the teeming slums. This week the UN's secretary-general, Ban Ki-moon, warned the biennial World Urban Forum meeting in Nanjing that 2 billion could be living in slums in the year 2030 and that "urban areas consume most of the world's energy and are generating the bulk of our waste."

Such fears of urban over-concentration are reflected in the policies of many different countries. Saudi Arabia is spending billions on new super-cities to ease the growth of Jeddah and Riyadh. Egypt is building 20 new cities to divert people away from Cairo. It plans 45 more. And attempts by poor countries to alter the course of urbanisation have a long pedigree in the rich world. In the 1950s and 1960s, Britain and France built lots of new towns to counter-balance their capitals' dominance.

Yet new research published by the World Bank in its annual flagship World Development Report* suggests that pessimism over the future of huge cities is wildly overdone. The bank argues that third-world cities grow so big and so fast precisely because

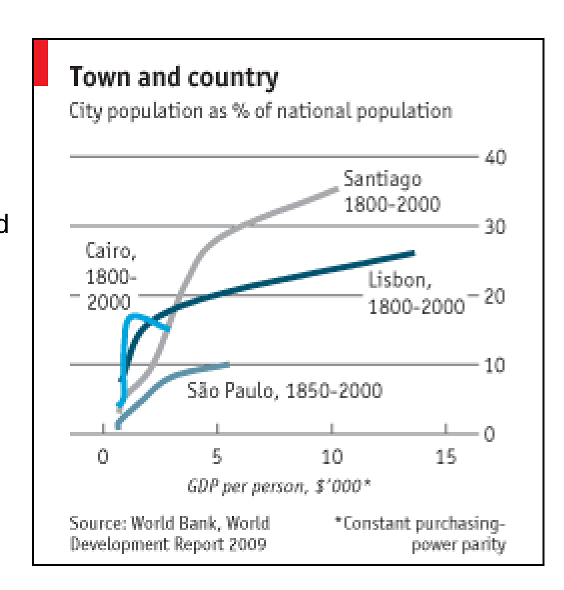
they generate vast economic advantages, and that these gains may be increasing. Slowing urbanisation down, or pushing it towards places not linked with world markets, is costly and futile, the bank says. At a time of contagion and bail-outs, the research also reaffirms the unfashionable view that the basic facts of geography—where people live and work, how they get around—matter as much as financial and fiscal policies. (The award of this year's Nobel prize for economics to Paul Krugman of Princeton University for his work on the location of economic activity was another reflection of that view.)



The bank's research yields lots of new insights. It argues, for example, that the share of humanity that lives in cities is slightly lower than most people think. The bank drew up a fresh index to get around the knotty problem of defining "urban"; this new measure puts the world's city-dwelling population at about 47% in 2000. In fact—as Indermit Gill, who oversaw the report, acknowledges—it is impossible to pinpoint the proportion: the urban slice of humanity may be anywhere between 45% and 55%, depending on how you count. The report's main point is that, whatever their exact dimensions, the Gotham Cities of the poor world should not be written off as a disaster simply on grounds that they are too big, too chaotic, too polluted and too unequal.

It is true that they are unprecedented in size. Mexico City, Mumbai, São Paulo and Shanghai each have over 15m people, whereas Paris and London, after their surge in the 19th century, had less than half that. The average population of the world's 100 largest cities now exceeds 6m. In 1900, it was only 700,000.

But relative to the size of countries' populations, the current growth is far from unusual. Between 1985 and 2005 the urban share of the population of developing countries rose by eight percentage points. Between 1880 and 1900, the bank says, the urban share in then-industrialising Europe and America went up by about the same amount. Over time, cities as disparate as Santiago (in Chile), Seoul, Lisbon and São Paulo have all followed strikingly similar paths, rising fast until they made up about a quarter of their countries' populations, then stabilising when the country's income hit about $5,000 per person (see chart). This path roughly tracks the transition of a country from an agricultural to an industrial base. Many countries are undergoing that sort of transition now, and therefore urbanisation is accelerating. But history suggests it will not go on rising at this rate for ever.



History also suggests that the income gaps that worry governments will narrow. As people move to the city, urban wages are typically 40-50% higher than unskilled farm earnings (that was the premium in Europe in the 19th century; it is about the same in developing countries today). But the income gaps of rich countries have narrowed, so living standards in the West today are roughly the same between town and country. That convergence is starting in poor countries, too: in poorer Malawi and Sri Lanka, city dwellers account for a much bigger share of consumption than of population (20% compared with 10%). But in richer Chile and Brazil, urbanites account for only slightly more consumption than population.

So one answer to the question—why are third-world cities so big?—is that they are not in relative terms all that large. But another answer, suggests the World Bank, is that they are big because they do an economic job that is becoming more, not less, important.

Cities are products of trade. Market towns trade crops. Second cities produce and trade manufactured goods. Metropolises design, make and sell everything, especially services. Over the past 50 years world trade has expanded hugely, especially in services, and giant cities have thrived correspondingly. Among the most striking of these urban success stories are cities in southern China that most people outside the region have never heard of because they were collections of villages just 20 years ago. Take, for example, Dongguan, in southern China. This little-known city in the Pearl River delta makes 30% of the magnetic recording heads used in hard drives across the world and 16% of the world's electronic keyboards. Its population has risen from tens of thousands 20 years ago to 7m today.

What has made such growth possible, argues the bank, is cheap transport. Falling transport costs in the 18th and 19th centuries enabled Britain and Portugal to trade wool and port (as the political economist David Ricardo memorably pointed out). Cheap transport in the past 25 years has produced a second sort of trade revolution. Countries now sell each other not final products like port but intermediate ones such as recording heads for hard drives. That has been made possible by an extraordinary fragmentation of production: every step in the production line is broken down. Parts are made separately, then shipped for assembly.

This matters because many of today's cities are places where lots of different factories turn out the same specialised components. In some ways, this specialisation and concentration of manufacturing seems strange: if parts can be made anywhere, it might appear more efficient to make them in the middle of nowhere, where land is cheapest. Yet factory owners like to cluster together because of the concentration of skills, as well as infrastructure, that cities offer. Workers with particular competences migrate to places where those skills are in demand—and all the businesses that need those skills benefit. Consumers, naturally, appreciate cities because it is easier to shop where goods are available in one place. And business services (banking, insurance, consultancy) cluster round the honeypot. Indeed, the usefulness of concentrating business services is all the greater in an era of much increased capital flows (the credit crunch notwithstanding). In short, the bank suggests a formula: the fragmentation of production lines, plus the clustering together of particular stages in the production line, plus cheap transport, equals higher productivity in the biggest cities.

If it is so important where economic activity takes place, what should countries do if they lack big cities—perhaps because they are landlocked, or cut off from world markets or have many poor people living in rural areas? These, the bank thinks, are the real problems of urbanisation, not the multiplication of slums or congestion. The answer, in the bank's view, depends on why people are cut off.

Teeming multitudes

World's largest cities' populations, 2007, m

City	Population	City	Population
Tokyo	35.7	Delhi	16.0
Mexico City	19.0	Shanghai	15.0
New York	19.0	Kolkata	14.8
Mumbai	19.0	Buenos Aires	12.8
São Paulo	18.8	Dhaka	13.5

Source: United Nations

If they are trapped in underemployment in remote rural areas, the main task is to establish land markets and basic services (schools, streets, sanitation) to help cities grow. This is the situation in much of Africa and remote parts of China, which last month took a few hesitant steps to liberalise its rural land markets. But countries are all too rarely willing to stand back and let cities grow: Tanzania and Ethiopia, to name just two, are busily trying to slow urbanisation down, despite the fact that three-quarters of their people are stuck in rural poverty.

Where urbanisation has started but pockets of the population are trapped far away, governments have to focus more on transport and other sorts of infrastructure to connect lagging regions with fast-growing ones. This is happening in western China, which is being linked up by air, road and rail with booming Chongqing. It is not until a more advanced stage of urbanisation is reached—with 75% of the population in cities (like, say, northern Egypt or Rio de Janeiro)—that it makes any sense to spend a lot on such policies as slum clearances, lest the now-teeming city is split apart by crime and grime.

These prescriptions have something in common. For poor countries, the key to development is to link up flagging and fast-growing regions. To do that, governments often overemphasise policies targeted on particular places. In practice, there are more powerful instruments of integration than "spatially targeted" efforts—eg, land markets that unify all places, or infrastructure that connects some places to others. Growth, says the bank, is inevitably lumpy. Governments must learn to like it.

---

* Available at http://www.worldbank.org/wdr2009.

The morning after

Nov 6th 2008
From The Economist print edition

After three decades of partying, Spain has woken up with a hangover. Curing it will require changes, writes Michael Reid (interviewed here)

AFP



THE past few months have been bittersweet for Spain. In a general election in March the Socialist Party won a clear but not overwhelming victory, giving José Luis Rodríguez Zapatero a second term as prime minister. That seemed to drain some of the partisan poison that had accumulated in the political system over the previous four years. In June Spain shook off its long-standing reputation as the permanent under-achiever of world football, winning the European championship with swift and skilful attacking play. Not only did the performance of its young team (featuring Catalans as well as the usual Madrileños in prominent positions) seem to echo Spain's flowering of creativity in everything from architecture to gastronomy; many commentators saw the footballers' triumph and the public's rapturous response to it as a welcome expression of national unity in a country that seemed to be turning increasingly fissiparous. In July Rafael Nadal, a tennis genius from Mallorca, won the Wimbledon championship. At the moment of victory he scampered across the press-box roof, clutching the national flag, to salute Spain's crown prince and his wife.

But every month since the election the news at home has become gloomier. Investment is slumping. Unemployment in August was 11.3%, a third higher than a year earlier, the biggest jump for 30 years. The economy grew by just 0.1% between the first and the second quarters of this year, the slowest pace since 1993. It is now almost certainly contracting. So sharp was the deterioration that Mr Zapatero (pictured above with Pedro Solbes, his finance minister), who had earlier refused to acknowledge that there was any economic crisis, interrupted his August break to hold an emergency cabinet meeting. "Spaniards went on holiday in party mood and came back to find there was no champagne left, nor even any decent wine," sums up Fernando Fernández, a former IMF official who is now rector of Nebrija University near Madrid.

Great while it lasted

The fiesta had indeed been splendid. Spain has undergone an extraordinary transformation since Francisco Franco died in 1975 and his long dictatorship came to an end. Democracy was swiftly consolidated. A deeply conservative Catholic society has metamorphosed into an almost self-consciously tolerant one. In the 1960s two-fifths of Spaniards still toiled on the land, many of them living in poverty. Now only 5% work in agriculture. Spain has become a vibrant, middle-class urban society.

Social and political change went hand in hand with economic progress. Between 1994 and 2007 the economy grew at an average annual rate of 3.6%. During that period unemployment fell from 24% to

8%, even though many women joined the labour force and some 5m immigrants arrived—and were absorbed with scarcely any sign of tension. For most of the past decade Spain has been responsible for creating about one in every three new jobs in the euro zone. By 2007 total employment had risen to 20m, from only 12m in 1993. When Spain joined the forerunner of the European Union in 1986 its income per person was only 68% of the club's average; in 2007 its income per person was 90% of that of the 15 EU members before its latest expansion. Living standards are now higher than Italy's.

The improvement in Spaniards' lives is instantly visible. Many elderly people are short, stunted by the hunger they suffered as children in the hard years of fascist autarky after Franco won the civil war of 1936-39. Young Spaniards are strikingly taller than their grandparents, exemplified by Pau Gasol, who measures seven feet (2.13 metres) and was voted the most valuable player when Spain won the latest world basketball championship.

Spain is not just a desirable place to live—though it is that, attracting northern Europeans who have bought second homes in order to enjoy the Spanish combination of sun, good public services and a relaxed way of life. In 2006 it was the world's ninth-largest economy measured at market exchange rates and the twelfth-largest at purchasing-power parity. It is the sixth-biggest net investor abroad.

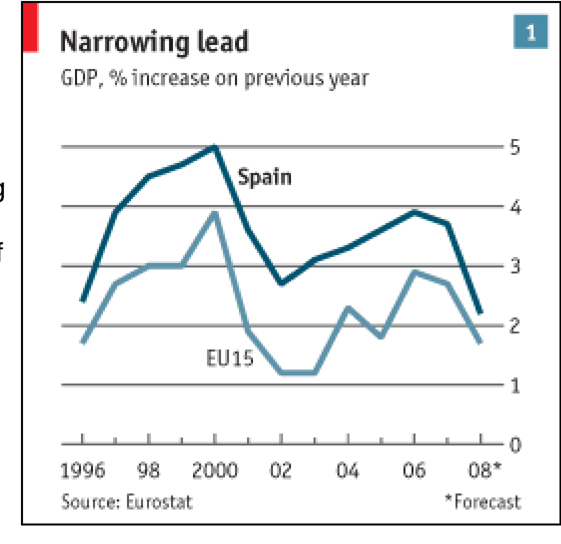
The economic boom began under Franco, who abandoned autarky in the late 1950s. He turned the management of the economy over to technocrats from Opus Dei, a lay Catholic organisation, who opened it to foreign trade and investment. But a bigger change came in 1986 when Felipe González, a Socialist prime minister, led Spain into Europe. Foreign direct investment flooded in as multinationals set up car and other factories to take advantage of relatively low wages.

The euro effect

Money from Brussels also poured in. Spain has been the largest single beneficiary of EU regional funds. It has received a total of €186 billion, most of which was wisely spent on improving roads and railways. Under Mr González's successor, José María Aznar of the conservative People's Party (PP), Spain qualified to join the euro at its inception in 1999. Interest rates fell dramatically: the cost of mortgages, for example, came down from 18% to below 5%, unleashing a housing boom.

Yet with a suddenness that has taken officials by surprise, economic boom has turned to bust. When the European Central Bank raised interest rates last year, the housing bubble burst. Higher oil prices also cut disposable income, as well as pushing inflation to a new high of 5.3% in July. And international financial turmoil has caused a credit squeeze at home.

Mr Zapatero points out that so far Spain has fared no worse than several other large European economies, and that the country's financial system is stronger than that of many of its counterparts: to date, no Spanish bank has got into difficulties. In an interview for this special report Mr Zapatero conceded that the economy faces a period of stagnation, but insisted that "once calm returns to the international system, we will return to growth without the Spanish economy having suffered structural damage." The government forecasts that after a year of almost no growth a recovery will start towards the end of 2009.



This strikes many as far too optimistic. Economists and businesspeople complain that the government was slow to respond to the economy's swift descent into recession. One of the country's most experienced bankers reckons that even if the outside world rights itself fairly quickly, recovery will not begin for at least two years. Some are even more pessimistic, arguing that in addition to the liquidity squeeze and the housing bust Spain suffers from an underlying lack of competitiveness. The symptoms are a current-account deficit that topped 10% of GDP in the first half of this year and an inflation rate that has been about one percentage point higher than the average for the euro zone for most of the past decade.

Fixing this will not be easy. When recession struck in the past, as it did in the early 1980s and again in 1993, the key to recovery was devaluation. But with Spain in the euro that option is no longer available. Unless the government rams

through structural reforms to make the economy more competitive, the argument goes, adjustment to a harsher economic environment will involve a big rise in unemployment and years of stagnation. Instead of going into a V-shaped recession, with a swift recovery, the economy could be heading for an L-shaped depression.

Spain's prosperity is due partly to good luck, in the form of EU entry. But for most of the past 30 years it has also managed its affairs far better than its southern Mediterranean peers have done. Despite some corruption, particularly in local government, Spanish politics is generally fairly clean. The country's economy is relatively open and flexible—halfway between Britain and the rest of continental Europe. Economic management has been mostly competent and stable: since 1993 Spain has had just two finance ministers (Italy has had four since 2001 alone). Mr Solbes, who has held the job since 2004, had an earlier spell in 1993-96 under Mr González before moving on to become the EU's commissioner for economic and monetary affairs. Under Mr Aznar the incumbent was Rodrigo Rato, who subsequently became the IMF's boss.

Officials reel off other reasons why Spain is now a different and stronger country than it was when recession last struck. For example, in 1993 the government had a budget deficit of 7% of GDP; in 2007 it had a surplus of 2.2% and public debt was just 36.2% of GDP, down from a peak of 68% in 1996 (compared with Italy's figure of 104% in 2007 or Britain's of 44%). Even more importantly, over the past 15 years a clutch of powerful Spanish multinationals has emerged. In 2000 the *Financial Times* list of the world's 500 biggest firms by market capitalisation included only eight from Spain; by 2008 the figure had risen to 14.

A generation of young Spaniards that has grown up knowing nothing but rapid economic growth may now have to contend with unemployment. This will put Spain's political system, as well as its economy, to its most severe test since the early years of its transition to democracy. This special report will weigh the country's strengths and weaknesses and assess its prospects for renewed economic growth. It will argue that Spain can avoid Italy's fate of seemingly remorseless decline. But there are some grounds for concern in politics.

Zapatero's gambits

Nov 6th 2008
From The Economist print edition

Flirting with nationalists, provoking the opposition

SIR JOHN ELLIOTT, a British historian and the foremost authority on Spain's imperial apogee in the 16th and 17th centuries, delivered a paper at Santander's Menéndez Pelayo University this summer in which he ventured that "the period between 1975 and 2000 may come to be seen in retrospect as a golden age of Spanish history." He went on to say that the past eight years "have seen the falling of shadows over what for a quarter of a century had seemed to be an increasingly sunny landscape". The shadows include polarisation, the re-emergence of dogmatism and "narrow-minded nationalism and localism".

Bridgeman Art Gallery



Goya's view of the politics of crispación

When Franco died, politicians across the political spectrum were determined to seek deals that would avoid the mistakes of the past. They blamed political maximalism from both right and left for plunging the country into the bloodletting of the civil war and its aftermath of repression in which about 600,000 people died. The constitution promulgated in December 1978 was preceded by a broad amnesty and contained some historic compromises. The left accepted a parliamentary monarchy instead of seeking to restore the Second Republic snuffed out by Franco. The right agreed to devolution for the Basque country, Catalonia and Galicia, which it had opposed (and annulled) in the 1930s.

A short-lived centrist grouping called the UCD governed during the transition and in 1981 survived the only serious coup attempt by diehard *franquistas*. Mr González, who was in office from 1982 to 1996, established a modern welfare state and began to shut down or privatise Franco's rusting state-owned steel works, shipyards and mining industries. In its final years Mr González's government was beset by corruption scandals. In a politically charged atmosphere dubbed *crispación* (roughly, "exasperated irritation"), he turned to the conservative Catalan nationalists of Convergència i Unió (CiU) for support.

The victory of Mr Aznar's People's Party (PP), which brought together former *franquistas*, liberals and much of the UCD, was an important milestone for the new democracy. It seemed to show that the right had embraced modern democratic conservatism. Lacking a majority, Mr Aznar allied with CiU and kept many of the Socialists' policies, adding tax and labour reforms. He also took a firm line against the terrorists of ETA (Euskadi Ta Askatasuna, or Basque country and Liberty), who had nearly killed him in a bomb attack in 1995.

Things began to change in Mr Aznar's second term when he had won an absolute majority and became increasingly high-handed. He secured a ban on parties that sympathised with ETA and treated the conservative Catalan and Basque nationalists with cold hostility. He backed President George Bush's war in Iraq with troops, even though polls showed that 90% of Spaniards opposed this. In a crowning moment of hubris he held his daughter's wedding at El Escorial, the monastery-palace of Spanish monarchs in the golden age to which Sir John Elliott harked back.

Bombshell election

To his credit, Mr Aznar stuck to his promise to step down after two terms. As his successor he chose Mariano Rajoy, a decent but plodding politician who seemed unlikely to overshadow him, rather than Mr Rato, his brilliant finance minister. Even so, the PP seemed set to win the 2004 election. But three days before the vote ten bombs exploded simultaneously on several Madrid commuter trains, killing 191 people and injuring more than 2,000 in the country's worst-ever terrorist attack. Mr Aznar tried to pin the blame on ETA. When it quickly became clear that the perpetrators were Islamist extremists, many Spaniards were outraged at this deceit—and confirmed in their view that the Iraq venture had made the country vulnerable. A huge turnout of voters gave the Socialists under their new leader, Mr Zapatero, a narrow and wholly unexpected victory.

Mr Zapatero represented a new generation whose political lives had not been shaped by dictatorship. Aged 43 when he became prime minister, he had been a schoolboy in León, in northern Castile, when Franco died. He had worked his way up the local party machine before narrowly winning the leadership of the Socialist Party against its grandees at a congress in 2000. Often derided as a lightweight, he has benefited from being underestimated by his opponents. The PP found it hard to accept its 2004 defeat and not to see him as an accidental prime minister or even a usurper. But Mr Zapatero has shown himself to be a skilled political tactician with a ruthless appreciation of power that has given him an iron grip over his own party.

In office he has kept his predecessors' macroeconomic policies, but in other ways pursued a different agenda. He began by fulfilling his campaign promise to withdraw the troops from Iraq, which earned him the enmity of Mr Bush. At home he stressed what he calls "the expansion of freedoms". His cabinets, in which Mr Solbes is one of the few survivors from Mr González's day, have contained many women—a demonstration of his commitment to equality of the sexes. Other reforms allowed for quick divorces and same-sex marriage, encouraged stem-cell research, penalised domestic violence and promised public money for the care of elderly or disabled people. All these measures "strengthen the idea of citizenship" and make for a "more creative, more tolerant society", says Mr Zapatero.

Most Spaniards agree with him. But the measures provoked the conservative bishops who head the Catholic church into protests against the government. Mr Rajoy, smarting from his election defeat, was happy to support them. Mr Zapatero thus manoeuvred the PP into portraying itself as more reactionary than the average Spaniard—and perhaps than it really is.

He took three more controversial steps which his detractors (and not just on the right) see as undermining the tacit understandings behind the constitutional settlement. The first was to challenge the "pact of silence", as some on the left call it, and reopen debate about the dictatorship. A law approved in 2007 offers government help and money for the relatives of those killed by the Franco regime, often dumped in unmarked graves, to find and rebury their dead. It also calls for all plaques commemorating the old regime to be removed from public buildings. Its supporters say that the law reflects the increasing maturity and self-confidence of Spanish democracy. It righted a clear wrong. The 60,000 or so civilians murdered by Republicans had long since been honoured. Some 150,000 executed by the victors during or after the war had not.

In the mid-1970s the priority for most Spaniards was to turn their back on dictatorship rather than to seek truth, justice or reconciliation. The attempt in 1998 by Baltazar Garzón, a maverick magistrate, to seek to extradite Chile's dictator, Augusto Pinochet, for crimes against humanity proved the catalyst for a shift in attitudes. Mr Garzón's initiative laid Spain open to the charge of hypocrisy, since none of Franco's officials had been held to account. It also prompted a new generation—the grandchildren of those who fought in the war—to organise civic groups that began to search for and dig up graves. In October Mr Garzón charged Franco and 34 of his (equally dead) henchmen with crimes against humanity. This may open the way for charges against others who are still alive. Many lawyers believe that Mr Garzón is on shaky legal ground.

It is to Mr Zapatero's credit that nobody now disputes that relatives should have the right to honour and rebury their dead. But some charge him with trying to politicise the issue. Many historians deny that the transition to democracy involved a "pact of silence". Juan Pablo Fusi, of the Ortega Institute, a postgraduate school, points out that the past 30 years have seen a deluge of detailed research, conferences, debates and television programmes on every aspect of the war and the repression.

Many feel uncomfortable with the idea that the state is upholding a particular view of the war which

ascribes all fault to Franco's nationalists and none to the communists and anarchists who also committed atrocities and undermined the republic. Fernando Savater, a philosopher who was jailed under the dictatorship for his political activity, notes acidly that the law is trying "to win the civil war now" and that "today Franco has many more opponents than when he was alive."

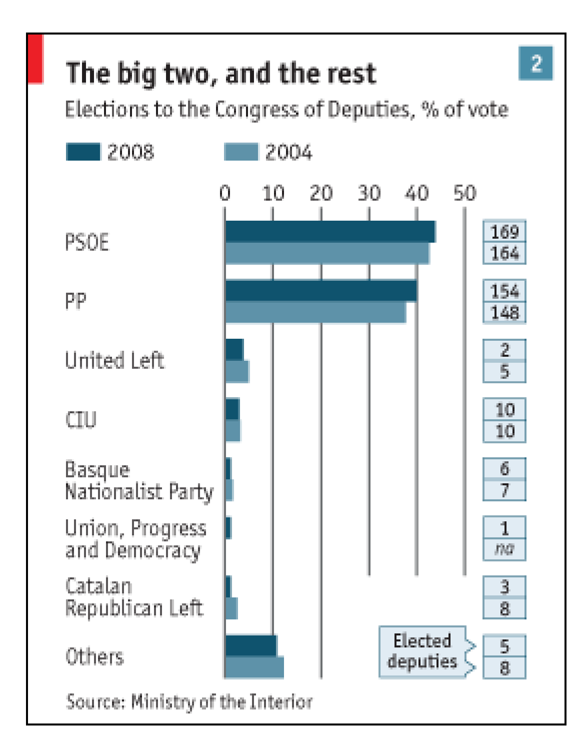
Unruly fringes

Even more controversial was Mr Zapatero's attempt to seek peace with ETA. The group has killed more than 800 people since 1968, but it has been greatly reduced, in numbers and in potency, by effective police work. Co-operation with France has denied its leaders their traditional refuge over the border. The March 2004 bombings caused widespread public outrage at terrorism. Two years later ETA declared a "permanent ceasefire". Talks took place between Patxi López, the Socialist leader in the Basque country, and Arnoldo Otegi, the leader of Batasuna, ETA's banned political wing, but they got nowhere.

The government rightly insists that it cannot make political concessions in return for an end to violence. It can negotiate about ETA's 600 prisoners (200 more are in French jails), but only with great caution. Public opinion, prompted by well-organised victims' associations, objects to early release for murderers. Conversely, officials say that Mr Otegi proved to have no sway over ETA's leaders. The government did allow a party of the "patriotic left" (the Orwellian term that ETA's political sympathisers use to describe themselves) to take part in municipal elections in 2007, and it got 7.4% of the vote in the three Basque provinces. But by then ETA had broken the truce: without any warning, a car bomb at Madrid's Barajas airport killed two Ecuadorean immigrants in December 2006.

Both Mr González and Mr Aznar had sought a negotiated peace with ETA, only to be similarly frustrated. But they had done so with the opposition's consent. This time the PP angrily accused Mr Zapatero of breaking an anti-terrorist pact between the two parties. As for ETA, officials say its violence is now rejected by many of its traditional supporters. "That suggests that one day it will end, and we are closer to the end than five years ago," says Alfonso Pérez Rubalcaba, the interior minister.

It is Mr Zapatero's entanglements with the legal nationalists of Catalonia (see map in next article), rather than with ETA, that will have a lasting effect. A few years ago some Socialists feared that Mr Aznar's PP had secured a long lease on power through economic success and alliance with CiU. The Socialists responded by moving closer to the nationalists. The Socialist leader in Catalonia, Pasqual Maragall, allied with Esquerra Republicana (ERC), a pro-independence party previously shunned because it rejects the Spanish constitution. This allowed the Socialists to take power in the region in 2003.



In office, the Catalan Socialist Party has shown itself to be as nationalist as the nationalists themselves. Mr Maragall demanded—and Mr Zapatero agreed to—the renegotiation of Catalonia's 1979 autonomy statute. The new statute, in a convoluted preamble, nods in the direction of recognising Catalonia as a nation, grants it privileged status within Spain and gives it more money and power. That has pleased many politicians in Catalonia. Seen from the rest of Spain, it looks at best unnecessary—Jordi Pujol, the CiU leader who headed Catalonia's regional government for 23 years, never pushed for it—and at worst another stride down a slippery slope that will end in the country's disintegration. In protest, some Madrileños even mounted a brief boycott of *cava*, the Catalan sparkling wine. The head of the army spoke out against the statute and was fired, in the first instance of military dissent for a quarter of a century.

Maria Dolores de Cospedal, the PP's general secretary, argues that some points in the new statute violate the constitution. It has yet to be approved by the Constitutional Tribunal. That body enjoys little prestige and includes few constitutional lawyers. Moreover, it has been paralysed for two years by a wrangle between the two main parties over the nomination of new tribunal members. Perhaps the biggest worry about the Catalan statute is that a measure of constitutional significance did not have bipartisan backing and appears to have been introduced for party-political advantage. Victor Pérez Díaz, a sociologist at Madrid's Complutense University, says that Mr Zapatero's Socialists "have crossed a line. They've broken

the spirit of the rules but not the rules."

The Catalan statute proved to be good politics. Mr Zapatero won his second term in March this year thanks to an overwhelming vote in Catalonia. As Ms de Cospedal points out, the PP outpolled the Socialists elsewhere. Mr Zapatero also did well among younger voters, who like his "expansion of freedoms"—and were left cold by Mr Rajoy. But despite four years of strong economic growth, Mr Zapatero did not win an absolute majority in the lower house of parliament. It was the nationalist parties, notably ERC, that were the main losers in the election. A senior official cites this as a vindication of the government's strategy of, in effect, killing nationalism with kindness (although that is not quite how he puts it).

Mr Rajoy did enough to cling on as the PP's leader, despite having lost two elections. At a party congress in June he replaced Mr Aznar's right-wing friends with new, younger and more centrist leaders, including Ms de Cospedal. He also hinted that it was time to drop *crispación* in favour of seeking consensus on some of the big issues facing Spain. In future Mr Zapatero may find the PP harder to provoke. The Socialists are talking about a new abortion law which their chief whip, José Antonio Alonso, calls the "biggest challenge" of this legislature. The PP thinks the existing law, which allows abortion in quite narrowly defined circumstances, should be properly applied rather than changed.

But according to Ms de Cospedal, in future her party will concentrate its attack on the economy. Mr Zapatero knows that he is in for a tougher four years than his first. "The first term was economically easy but politically difficult. This term will be politically easier but economically more difficult," he acknowledges. The chances are that he will face trouble on both fronts.

How much is enough?

Nov 6th 2008
From The Economist print edition

Devolution has been good for Spain, but it may have gone too far

THE hardest problem for the authors of Spain's democratic constitution was to strike a balance between the central government and the claims of Catalonia, the Basque country and Galicia for home rule. The formula they came up with was known as *café para todos*, or coffee for all: Spain was divided into 17 "autonomous communities" (plus the enclave cities of Ceuta and Melilla on the Moroccan coast), each with its own elected parliament and government. This *estado de las autonomías* seemed a neat solution. Over the past 30 years more and more powers and money have been devolved. The regional governments are now responsible for schools, universities, health, social services, culture, urban and rural development and, in some places, policing. But it is becoming clear that even as it has solved some problems, decentralisation has created others.

The *estado de las autonomías* has several clear benefits. First, as Mr Zapatero says, "it spreads power and impedes its concentration," and in that way reflects "the best liberal thinking". Second, by bringing decisions about services closer to the people it has improved them. Third, it encourages competition between regions. The rivalry between Barcelona and Madrid may have acquired an edge of mistrust, but it is in essence a creative tension. And fourth, the system has reduced regional inequalities, or at least stopped them widening.

To get a sense of the success of decentralisation, head not to Catalonia or the Basque country but to the south. In the 1970s Andalucía seemed much closer to Africa than Europe—and not just geographically. Rural labourers lived in semi-servitude and one adult in five was illiterate. Now it has narrowed the gap with the rest of Spain in many ways. The south is still poorer than the north, but Spain no longer has anything like Italy's *mezzogiorno*.

In other parts of the country Valencia and Zaragoza have become thrusting cities with an economic and cultural life of their own, and Bilbao's metamorphosis from a centre of declining heavy industry into a cultural and tourist magnet, started off by its Guggenheim Museum, has become a textbook case of urban regeneration.

All this has come at a political price. First, it has led to a renaissance of an old Spanish political phenomenon, the *cacique* or provincial political boss, as Antonio Muñoz Molina, a leading novelist, points out. Mr Pujol ran Catalonia for 23 years; Manuel Fraga, a former minister under Franco who founded the forerunner of the PP, ran Galicia for 15 years; and Manuel Chaves, a Socialist who has headed Andalucía's regional government since 1990, is said to reign rather than govern.

These modern princes have their courts. "Every regional government wants its own universities, contemporary-art museum and science museum," says Josep Ramoneda, who heads the Centre for Contemporary Culture in Barcelona. "In the United States there's only one Hollywood. Here they want 17." In Andalucía the regional government is by far the biggest employer, and the biggest advertiser in the regional press. Every regional government has its own television station. Mr Zapatero has taken to holding regular "presidents' conferences" with his regional counterparts. The latest one attracted 600 journalists. "It looked like the UN General Assembly, with six or seven satellite trucks outside," notes Enric Juliana, a journalist for *La Vanguardia*, a Barcelona newspaper.

The regional governments even get involved in foreign policy. Some have aid budgets. Mr Muñoz Molina, who was the director of the New York office of the Instituto Cervantes, a body to promote Spanish culture, recalls that regional presidents would turn up in the city with vast entourages. Most of these missions were badly organised and achieved nothing except favourable coverage in their captive media.

Coffee just for us

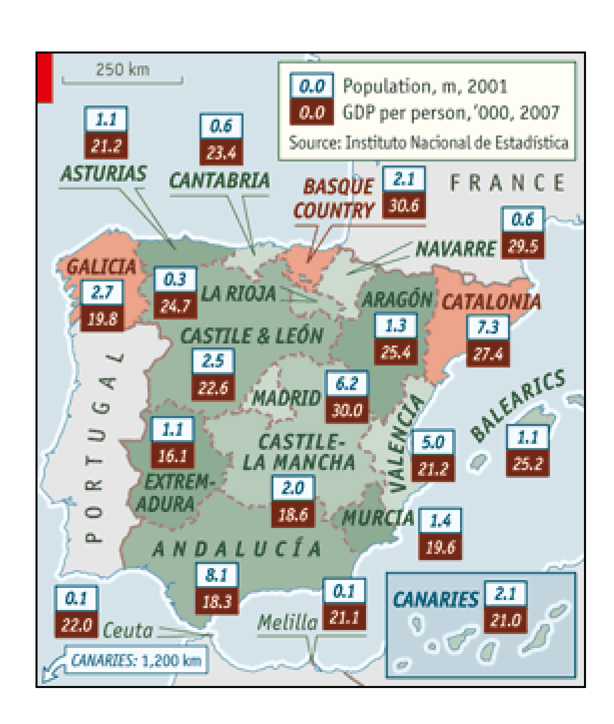
But this panoply of decentralisation has not placated the politicians in Catalonia, the Basque country and

Galicia. That is because they never wanted *café para todos*: they wanted it just for themselves, as a recognition that they were different. They still want that, no matter that Spain is now an extraordinarily decentralised country in which the Basques, for example, enjoy a greater degree of home rule than any other region in Europe. Their demands make it difficult to draw up a stable and permanent set of rules.

Catalan and Basque "nationalists" argue that unlike, say, La Rioja or Murcía, their territories are nations, not regions (nor "nationalities", in the tortuous formulation of the constitution), and invoke history to support their claim. "Here the conflict dates from 1836," insists Joseba Aurrekoetxea, a leader of the Basque Nationalist Party (PNV), referring to the Carlist war after which the central government revoked the Basques' fiscal privileges (restored in 1979). "Catalonia was always distinct," says Artur Mas, who replaced Mr Pujol as leader of CiU. It descends from the medieval kingdom of Aragón, and rebelled against Madrid in 1640 and in 1701.

But Catalan and Basque nationalism are creations of the late 19th century. They stem from industrialisation, which made these the richest regions in the country, taking in migrants from elsewhere in Spain. At the time the Spanish state, unlike its French counterpart, lacked the resources to integrate the country, says Antonio Elorza, a Basque political scientist at Madrid's Complutense University. Otherwise Catalonia and the Basque country would have been as content within Spain as Languedoc and Brittany are within France.

Perhaps because the historic claim to nationhood is shaky, language has become an obsession for the nationalists. Franco banned the public use of Catalan, Euskera (Basque) and Gallego. The constitution made these languages official ones alongside Spanish in their respective territories. In Catalonia the official policy of the Generalitat (the regional government), under both the nationalists (some of whom are really localists) and now the Socialists, is one of "bilingualism". In practice this means that all primary and secondary schooling is conducted in Catalan, with Spanish taught as a foreign language. Catalan is also the language of regional government. A Spaniard who speaks no Catalan has almost no chance of teaching at a university in Barcelona. A play or film in Spanish will not be subsidised from public funds. "If we don't make a big effort to preserve our own language, it risks disappearing," says Mr Mas.



Catalan and Spanish are more or less mutually comprehensible. Not so Euskera, which does not belong to the Indo-European family of languages. The Basque government allows schools to choose between three alternative curriculums, one in Euskera, another in Spanish and the third half and half. But in practice only schools in poor immigrant areas now offer the Spanish curriculum. Despite these efforts, Basque and Catalan are far from universally spoken in their respective territories: only around half of Catalans habitually use Catalan and about 25% of Basques speak Euskera.

The nationalists' linguistic dogmatism is provoking a backlash. Earlier this year Mr Savater, the philosopher, together with a diverse group of public figures ranging from Placido Domingo, a tenor, to Iker Casillas, Real Madrid's goalkeeper, signed a "manifesto" in defence of the right of citizens to be educated in Spanish. They were denounced as "Castilian nationalists" in the Socialist press. But they

touched a nerve. Many thoughtful Catalans believe that Catalan would be safe if it remained the language of primary schools, but that Catalonia would gain much by allowing a choice between Catalan and Spanish in secondary schools.

The power of language

The argument about language is really about power. “The problem with nationalists is that the more you give them, the more they want,” says Mr Savater. What some of them want is independence; all of them use this as a more or less explicit threat to gain more public money and powers. The polling evidence suggests that no more than a fifth of Catalans are remotely tempted by the idea of independence. The figure for Basques is around a quarter, despite 30 years of nationalist self-government and control of education and the media, and despite the departure of around 10% of the population because of ETA’s violence, points out Francisco Llera, a (Socialist) political scientist in Bilbao.

ETA’s political support is declining, though not vanishing. The PNV is split between a pro-independence wing led by Juan José Ibarretxe, the president of the regional government, and home-rulers in the party leadership. Mr Ibarretxe wants to hold a referendum on the right of Basques to self-determination. Mr Aurrekoetxea argues that ETA should not have a veto over whether Basques can peacefully express a view on the future.

The government, parliament and the courts have all blocked the referendum plan “because it is against the constitution”, says Mr Zapatero. “It would make ETA right in fighting on the basis that this is an oppressed people,” says José Antonio Pastor, a Basque Socialist. He and many other non-nationalist politicians and their families must live with round-the-clock bodyguards. In parts of the Basque country, in the tight rural valleys on the borders of Vizcaya and Guipúzcoa, non-nationalists cannot campaign freely. The Socialists hope to win a Basque regional election due in March. To improve their chances, they are following their Catalan peers in embracing cultural nationalism.

Buying off the Basque and Catalan nationalists with more money has become harder. The central government now accounts for just 18% of public spending; the regional governments spend 38%, the *ayuntamientos* (municipal councils) 13% and the social-security system the rest. But under the new Catalan autonomy statute more money has to be devolved. Over the next seven years Catalonia will have to be given a share of public investment equivalent to its weight in the Spanish economy, which will amount to an extra €5 billion a year. Previously Catalonia, although Spain’s fourth-richest region, received less public spending per head than several others. It complains that its commuter trains, in particular, have been starved of funds.

The Basques have no such worries: each Basque province and Navarre collect their own taxes and hand over less than 10% to the central government in Madrid. But they benefit from central-government defence spending, and they are net recipients from the social-security system. As a result, public spending per person in the Basque country is the highest in Spain.

The new Catalan statute requires the government to strike a new regional financing deal, even though the one in 2001 was supposed to be final. But it is to the central government that Spaniards will look for unemployment benefits and for spending to alleviate recession. Local governments are likely to suffer budget cuts by 2010, if not next year.

The government’s ability to carry out economic reforms is also compromised by decentralisation. As regional governments acquire more and more power to regulate, businesses face higher compliance costs. Now that the government employment service has been decentralised, José María Fidalgo, the general secretary of the Workers’ Commissions, the largest trade-union federation, worries that jobseekers have to look at 17 different websites.

It would have been easier for all concerned if Spain had adopted federalism in 1978. That would have set clear rules and aligned responsibilities for taxing and spending. The Senate could have become a place where the regions were formally represented and could settle their differences, akin to Germany’s Bundesrat. But the Catalan and Basque nationalists will only accept a confederation of several “nations”. The PP also opposes federalism.

In the meantime Spain must muddle on. “The great Spanish project is not in danger, but it’s like a plant that requires constant tending,” says Narcís Serra, who used to be Mr González’s vice-president and now runs Caixa Catalunya, a savings bank. “It’s important that Catalonia is comfortable in the project.” The

government in Madrid could make some gestures to the regions, such as moving some regulatory agencies or other national bodies out of the capital. And would it really be the end of Spain if the Basques, like the Welsh, had their own national football team?

Elsewhere in the country anti-nationalism is starting to stir. Mr Savater and Rosa Díez, a former Basque Socialist leader, have set up a new party of the radical centre called Union, Progress and Democracy (UPyD), in an effort to combine social liberalism with a defence of the idea of Spain. They hope to profit from the rising disillusion with both the main parties. Even though it lacked money and access to the media, it won 1.2% of the vote in the March election, the same as the PNV. But because the electoral system disproportionately rewards geographically concentrated votes, the UPyD secured only one deputy, Ms Díez, against the PNV's six. It hopes to do better in an election to the European Parliament next June, for which the whole country will count as a single constituency.

Banks, bricks and mortar

Nov 6th 2008
From The Economist print edition

An already solid financial system faces more consolidation

ON THE outskirts of every Spanish city and town, and even some villages, you will see neat rows of houses or blocks of flats in various stages of (in)completion. Cranes rise in their midst. Newly tarred roads with street lights continue on into vacant land. All is silent. What hit Spain was a combination of its own excesses and the effect of toxic financial assets elsewhere. When the first signs of the credit crunch appeared in August 2007 Spain was in a frenzy of building, putting up some 700,000 new housing units a year—more than France, Germany and Italy combined.

AFP



Temples of growth—and greed

Thanks to immigration, Spain's population has increased from 40m to 45m since 2000. Even so, only 400,000 new households are set up every year; in addition, some 150,000 foreigners buy houses, mainly northern Europeans in search of second homes. The construction boom was exaggerated by a potent mixture of perverse incentives. First, money was cheap after Spain adopted the euro. In setting interest rates, the European Central Bank is guided mainly by economic conditions in Germany and France. Because of Spain's higher inflation, interest rates there were close to zero in real terms.

Second, policy and culture interacted to make a housing bubble more likely. Mortgage-interest payments are partially deductible from income tax. Total fiscal subsidies for home-ownership equal around 1% of GDP, according to the OECD. In the 1950s half the population rented. But the law heavily favours tenants over landlords, which caused a shortage of rented property. As Spaniards got richer they poured their savings into housing. Fernando Encinar of Idealista.com, an online estate agency, notes that Spain has about 50% more homes than it has households. Many middle-class families have a second home near the beach or in the grandparents' village in the country, or as an investment. There is no tax on empty property.

The third factor was a powerful nexus of local politicians, property developers and the *cajas de ahorros* (savings banks) that make up half of the country's financial system. Spanish towns are typically quite dense, ending abruptly in open countryside. Building on vacant land requires the *ayuntamiento* to extend the town limits, which then entitles it to 10% of the development land. Selling this 10% back to the developer became a main source of revenue for many *ayuntamientos* (sometimes councillors also got bribes to approve the new developments). In turn, the local politicians who control the *cajas*, which are quasi-mutual outfits, provided the developers with loans. With house-price rises averaging 12% a year for most of this decade, it seemed like a one-way bet.

Then the bet suddenly turned sour. The *costas* were hit first. Overbuilding and the popping of the housing bubble in Britain (the largest single source of second-homers) caused prices to slump. Next, the credit

squeeze kicked in with a vengeance. Now almost 1m unsold homes sit vacant across the country. Prices of existing homes in Barcelona and Madrid have fallen by up to 10% in the past year. Mr Encinar reckons that average prices will fall by up to 50% in nominal terms (though rather less in real terms) before they stabilise.

The first casualties have been estate agents. In Malaga at the peak there were more estate agents than hairdressers, says Mr Encinar. Half those offices have closed in the past year. The next victims are the property companies. The biggest, Martinsa-Fadesa, collapsed in July, owing €5.2 billion, the largest bankruptcy in Spanish history. Others are in trouble, partly because they are sitting on land banks of uncertain value. Then come the *cajas*. The average of overdue loans in the financial system has already climbed to 2.5% of all loans; for the *cajas* the figure is 2.9%. José Viñals of the Bank of Spain, the central bank, insists: “We don’t see any financial entity whose viability is compromised.” But he adds that banks and *cajas* will have to adjust their cost structures to slower growth. Mr Zapatero has said that some *cajas* should merge and that the government should help them to do so.

A private banker is blunter. He expects the coming recession to reshape the Spanish financial system, as did the recessions of the early 1980s and early 1990s. He reckons that around a dozen of the smaller *cajas*, mainly on the Mediterranean coast, will have to be bailed out by merging with stronger ones, perhaps with government support. Some smaller banks may be sold to foreign institutions.

If the damage turned out to be no worse than that, it would be tribute to the strength of Spain’s financial system. So far there has been no Spanish equivalent of Northern Rock, a British mortgage lender that had to be nationalised, let alone a Fortis or a Lehman Brothers or AIG. That is because those earlier recessions and their attendant bank collapses bequeathed both sound regulation and relatively conservative banking practices. As the financial boom got under way, the Bank of Spain introduced a countercyclical element to loan-loss provisioning. “We think that risk arises not when a loan becomes overdue but when it is granted,” says Mr Viñals. So banks have to set aside a small generic provision when issuing a loan, as a kind of insurance policy. The Bank later obliged any institution setting up an off-balance-sheet Special Investment Vehicle to take a large capital charge—large enough to dissuade them from doing so.

The solid few

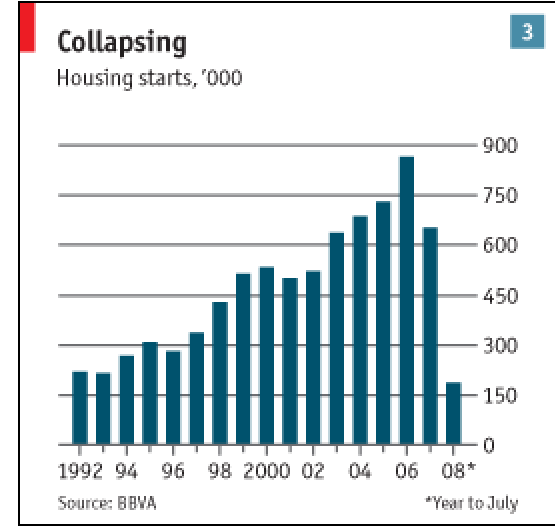
After the frantic consolidation of the early 1990s Spain is left with two giant banks, Santander and BBVA; a handful of middling ones; scores of smaller ones; and 45 *cajas*. It is the *cajas* that have the biggest exposure to mortgages and property developers, partly because the two big banks have chosen to grow abroad.

Both Santander and BBVA have a strong capital and deposit base and have largely stuck to commercial banking, eschewing investment banking and derivatives. Spain accounts for only 35% of Santander’s total business. “We’ll clearly see slower growth, an increase in overdue loans and a demand for higher provisions,” says Alfredo Sáenz, the group’s chief executive. The bank has spent €2.5 billion buying assets from its property-company clients as a pragmatic way of reducing bad loans. In some cases it has had to accept a loss on these assets. Against that, margins are widening. Santander’s profits in Spain have been growing at 20% a year. Mr Sáenz expects that figure to remain in double digits, but that will require cost-cutting, including early retirement of some of the bank’s staff.

Spain accounts for 40% of BBVA’s profits (and Mexico for 26%). Francisco González, its chief executive, notes that the bank has generic provisions of €3.5 billion and should be able to deal with an increase in overdue loans without profits being affected. The bank’s net income is still growing at 10%, he says, compared with over 20% last year. “We’re comfortable with our capital position, have a lot of liquidity and relatively good asset quality in relation to creditors,” he adds. “We’ll pass through a storm, there’ll be wounds, but those who emerge will be winners.”

The third-largest financial group is Barcelona’s La Caixa, the biggest of the *cajas*. Two-thirds of its loans are mortgages and another 12% are to developers and building firms, according to Juan María Nin, its chief executive. But it has a large cash pile,

is well capitalised and can draw on a portfolio of industrial investments, which includes big stakes in Telefónica, two energy companies, Gas Natural and Repsol, a water utility, Agbar, and a toll-road operator, Abertis. It has recently taken stakes in banks in Hong Kong and Mexico as it seeks to follow the big two banks in expanding abroad.



Mr Nin says that defaults on Spanish home loans will be relatively low, for several reasons. Almost 90% of La Caixa's mortgages had a loan-to-value ratio of less than 80% in June; the average was 50%. Spanish banks insist on guarantees; homeowners and their guarantors remain liable for the mortgage payments even if they hand back the keys of the property. And when workers are laid off they are entitled to unemployment benefits worth 80% of their pay for 18 months.

So the direct effect of the property bust on the financial system should be containable. But that is not the end of the story of woe. The slowdown in consumption and the international credit crunch is hitting the rest of the economy—and will eventually hurt some banks. Both Spain's government and its businesses are less indebted than they were last time recession struck, but households are deeper in the red: total household debt is equal to 84% of GDP (still a smaller share than in Britain, Ireland or the Netherlands). No wonder that in the first nine months of 2008 sales of new cars were down 22% on last year.

Though Spanish banks have a strong deposit base, until a year ago they were refinancing some €100 billion a year in the markets, partly by issuing *cédulas hipotecarias*. These are 15-year covered bonds backed by prime mortgages and guaranteed by the bank's assets (Spanish banks keep mortgages on their books even after they have securitised the debt). Now they are being confused with subprime mortgages and nobody is buying them, says Guillermo de la Dehesa, the (Spanish) chairman of the Centre for Economic Policy Research, a London-based group. As an alternative the banks and *cajas* are borrowing from the European Central Bank's emergency liquidity window, but this is a short-term stopgap. The stronger banks can still issue short-term notes.

Squeezed, not crunched

Both the government and blue-chip companies are finding credit more expensive. Government bonds now attract a risk premium of some 60 basis points (ie, 0.6 %) over their German equivalents, and companies have seen the cost of loans rise by up to three times that amount. So far, however, Spain has faced merely a credit squeeze rather than a full-blown crunch in which credit is no longer available, says Mr de la Dehesa.

That is not how it feels to many businesses, hit by lack of liquidity and slowing consumer demand. Having previously rejected calls from bankers and businesspeople to inject liquidity into the economy, the government ended up matching rescue measures taken by Britain, the United States and others. Last month Mr Zapatero announced a €50 billion fund to help the banking system. This will buy *cédulas hipotecarias* and bundles of bank loans, but only those with a triple-A credit rating. The government also raised its guarantee on bank deposits from €20,000 to €100,000. Days later it offered to guarantee up to €100 billion of bank borrowing this year and an unspecified sum next year, as part of a co-ordinated European effort to ungum the money markets.

The government had already done some fiscal pump-priming earlier. Shortly after the election it announced a €400 rebate for every taxpayer, half of it paid in June and the other due in December. But falling tax revenues have swiftly pushed the public finances into the red. The draft budget foresees a deficit of 1.5% of GDP this year and 1.9% next. The banking fund will help to push the public debt up to 38.8% of GDP next year.

In September Mr Solbes announced a €3 billion credit line to encourage property companies to let out their empty flats. But that will only slightly reduce the stockpile of unsold homes. Reviving the rental market requires a new law to help landlords.

The sooner house prices fall, the faster Spain will recover from the bust. The housebuilding industry needs to shrink from a swollen 9% of GDP in 2007 to a more normal 5% or so. Mr Solbes says that this

year 160,000 fewer houses are being completed than in 2007, which alone implies a 1% fall in GDP. Yet each job in the building industry also generated three or four jobs indirectly, says Mr Fidalgo. With housebuilding knocked out as the engine of growth and employment, Spain will have to find something to replace it.

In search of a new economy

Nov 6th 2008
From The Economist print edition

But reforming the old one is just as important

DOWN on the Barcelona waterfront, on what used to be industrial wasteland before the area was developed for the 1992 Olympic games, a striking new building of wood and glass houses the Barcelona Biomedical Research Park. It is a joint venture between the Generalitat, the Barcelona city council and Pompeu Fabra University. Some 800 scientists, about a third of them foreigners, work at the long white benches with their jumble of flasks, instruments and computers. The six different research groups scattered around the building span various aspects of biomedicine, epidemiology and genomics.

Some €40m of the park's annual budget of €65m comes from research grants. In the past 15 years Spain has risen fast in the world league-table of articles published in scientific journals, to ninth place. Jordi Camí, a neuroscientist who is the research park's founding director, hopes to use “the glamour of Barcelona” to attract leading scientists from around the world and compete for talent with London, Singapore and Cambridge, Massachusetts.

No wonder Mr Zapatero came to open the building in August last year. The research park exactly matches his government's idea of Spain's “new economic model”, in which brainpower is more important than the muscle of building workers or the sun and sand of tourism. To that end he has created a new Ministry of Science and Innovation. The minister, Cristina Garmendia, is a founder of Genetrix, a biotech start-up which she says is about to become the first European company to launch a drug derived from stem cells.

Public spending on research and development has tripled since 2000. The problem is that private spending is negligible. The answer, says Ms Garmendia, is to build bridges between universities and companies. Spain is poor at turning research into patents and products. Investment in biotech, for instance, is now €60m, up sixfold in eight years, but still only a tenth of the British or German total.

Miguel Sebastián, the industry minister, talks up Spain's growing prowess and potential in a long list of innovative businesses, ranging from renewable energy to aerospace and information technology. In some of these Spain is already a world leader. Take a high-speed train across the *meseta*, the high plain with hot, arid summers and harsh winters that covers much of Spain, and your eye will be caught by batteries of upturned solar panels along the tracks, tilted to catch the relentless Spanish sun. The mountain ridges that corrugate the *meseta* are crowned by gigantic wind turbines—an appropriate sight in the land of Don Quixote.

The renewables industry is subsidised, as it is everywhere, but the country now gets 22% of its electricity from this source, and three of the world's five biggest renewables companies are Spanish. They are developing a world-class network of technologically sophisticated suppliers, and costs are falling as the technology improves. But the country, which has to import all its gas and oil, needs a broader discussion about energy policy. The PP wants an urgent debate on whether to expand nuclear power. Mr Zapatero does not.

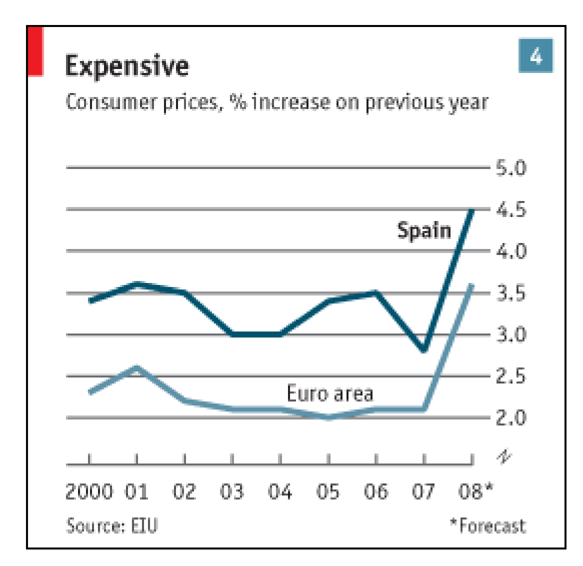
Plodding productivity

Innovation takes time, and on its own it is not enough: Spain also has to make its existing economy more efficient. “We need to raise productivity in hotels and retail as well as in biogenetics. We need to do everything better, starting with education and regulation,” says Mr Rato, who now works for Lazard, an investment bank.

Productivity growth has traditionally been slow in Spain. According to the OECD, between 1990 and 1997 it averaged just 0.3% a year, a third of what it was in Germany, France and Italy, the three largest euro-area economies. And more recently things have got worse: the OECD reckons that between 1998 and 2006 total factor productivity (ie, the combined effect of labour, capital and technology) actually fell by

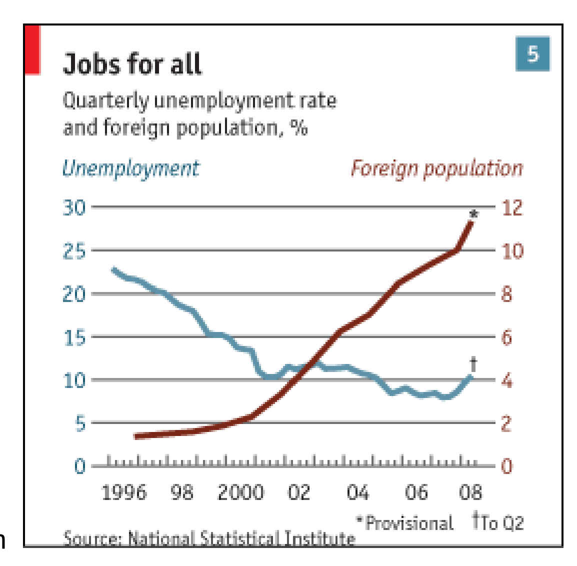
0.2% a year. A Spanish government study disagreed, finding that productivity rose during that period, but only by around 0.3% a year, and that half of the country's economic growth came from immigration. Part of the explanation for the poor productivity figures is that many new jobs were in low-value-added businesses.

Another reason is the quality of Spanish education, which seems to be declining. William Chislett, of the Royal Elcano Institute, a think-tank, points out that one in three secondary pupils now drops out, double the EU average, and that 70% of 14- and 15-year-olds in Madrid fail their maths exams. Teachers complain that their profession has lost status. School management has been transferred to regional governments without introducing national standards or a national inspection system. The debate about schooling in the past four years has been mainly about Mr Zapatero's insistence on civics lessons, which many feel is a side issue.



The state of the universities is little better. Spain has three world-class business schools, IESE, IE and ESADE, all privately run. But no Spanish university appears in the list of the world's top 150 compiled by Shanghai's Jiao Tong University. Spain's public universities, which make up the vast majority, are trapped in a rigid, bureaucratic system that offers few incentives to strive for excellence, says Mr Fernández of Nebrija University (which is private). Rectors are elected by assemblies of students, professors and administrative staff and are not accountable to anyone else, but in practice they lack the tools to manage their institutions. The result is a paradox. "Universities have autonomy: they can do whatever they want as long as they do the same as everyone else," says Xavier Vives, an economist at IESE. Universities have been handed to Ms Garmendia's new ministry. She agrees that their governance needs reform and that they should be encouraged to specialise. But she may lack the political weight to achieve this.

Productivity faces other constraints as well. For a start there is too much red tape, To make things more complicated, some aspects of the regulation of business are now handled by regional governments. Some parts of Spain, such as Catalonia, have laws to restrict shopping hours and block out-of-town stores, aimed at preserving small food shops (many of which are now run by Chinese immigrants) and preventing suburban sprawl (from which Madrid, more liberal in these matters, now suffers). But this comes at a cost. José Luis Escrivá, BBVA's chief economist, thinks that such restrictions on retailing are one reason for Spain's higher inflation; he notes that Catalonia tends to have higher inflation and slower growth than Madrid.



Spain has built an impressive network of motorways and high-speed trains, known as AVEs. Mr Zapatero boasts that by 2010 it will have more kilometres of high-speed railway than any other country in Europe, and that every Spaniard will live within 50 kilometres (30 miles) of an AVE station by 2020. The punctual and comfortable AVE links Madrid and Barcelona in just 2 hours and 40 minutes.

But Spanish companies find that it can cost up to three times as much to get their goods to the French border than from there to Poland, says Jordi Canals, the dean of IESE. That is partly because of Spain's difficult geography, but also because nearly all goods go by road rather than by rail. It would have been more sensible to upgrade the existing railway network for both freight and passenger trains rather than to build the expensive AVE network. A train from Barcelona to Bilbao, for example, takes at least nine hours in grubby carriages built in the 1960s. In theory the AVE network could be used for freight trains at night. The government says it will introduce competition on the railways and privatise RENFE, the state railway company. But nobody expects this to happen soon.

Spaniards as individuals are almost unfailingly friendly and kind. But when they have to serve customers, something strange often happens: they become defensive and unhelpful. The ministers say they hope to use the EU directive on competition in service industries to shake up these industries and expose them to more competition. The first step is a bill to cut back red tape for these businesses.

Slow justice

They would do well to move on to the judiciary. “We’re still to a large extent in the 19th century,” says José Antonio Martín Pallín, a retired justice of the supreme court. The courts still follow a procedural code dating from 1882. Evidence is mainly in writing, with little oral testimony and many opportunities for delay. A typical civil case can take up to eight years, says Mr Martín. For example, it took ten years for the courts to decide that Marbella’s urban-development plan violated environmental-protection laws: this ruling now requires some 30,000 homes to be demolished.



Things move so slowly partly because of a shortage of judges, but also because the courts have stuck to the relaxed working hours they got used to under the Franco regime. Administrative staff in the higher courts work only in the mornings but are paid for a full day’s work.

Problems in the labour market also bear some of the blame for Spain’s low productivity. The country’s trade unions are unusually moderate, having learnt that unreasonable wage demands in the 1980s led to unemployment in the early 1990s. Mr Sebastián claims that wages in real terms have not increased over the past decade, despite the rapid growth in employment. That is partly because of reforms introduced by Mr Aznar but mainly because of increased flexibility thanks to immigration. The upshot, though, has been a dual labour market: some 30% of the workforce are governed by temporary contracts and have no job security, whereas the other 70% enjoy protection that makes sacking them expensive and difficult. This arrangement holds down both wages and permanent employment.

Moreover, permanent workers are used to annual pay increases indexed to inflation under nationally negotiated agreements. A manager at a Spanish industrial company with factories abroad points out that his workers in Germany have agreed to longer hours with no extra pay, and that those in America have accepted a pay increase below the rate of inflation. Unless his Spanish trade unions follow suit, he says, he will have to lay off workers.

The government has begun a “social dialogue” with the unions and the private sector. Mr Fidalgo, of the Workers’ Commissions, a formerly communist trade union, talks so eloquently about the need to make the economy more competitive that you might mistake him for a World Bank official. But he does not think that labour needs to become more flexible. His main concern is to make sure that the government finds the money to pay unemployment benefit (which it has said it will) and to reform the state employment service.

Mr Zapatero says that the government will not implement any changes that do not have the support of both unions and business: “Any reform without that understanding is not very useful.” That suggests the talks may not achieve much. Some firms will doubtless make local agreements with the unions; certain car factories, for example, are imposing shorter working hours. But there is a strong possibility that increased competitiveness will be achieved through job cuts.

Many of the steps required to make the economy more efficient are outlined in the government’s 2005 national reform plan, but Mr Zapatero’s detractors claim that he has been slow to implement this. Most of the obvious structural reforms had already taken place before he came to office: for example, the central government has little left to privatise. Much of what is now needed involves offering the right incentives—

to run universities and schools better, to hire rather than fire workers and to become more efficient. Such reforms are not easy politically, and do not produce quick results, argues a former minister in Mr Aznar's government. He worries that Mr Zapatero is sending the wrong message to Spaniards—"the idea that you don't need to worry, we'll cover your needs".

In August the prime minister chose a political rally to announce a 6% increase in pensions, even though the government might have done better to husband its reserves to cope with an ageing population now that immigration is tailing off. "The issue of reforms is not always linked to economic growth, as it should be," concedes Mr Solbes. "The prime minister is more sensitive to the issue of social rights." Recession may change Mr Zapatero's priorities. But for the moment Spain's best hope of recovery lies with an impressive array of multinational businesses.

 SPECIAL REPORTS

A cooler welcome

Nov 6th 2008
From The Economist print edition

Attitudes to immigration are turning more cautious

FOR much of the Middle Ages, after the invasion of Muslim Berbers and Arabs in the eighth century, Spain was a multicultural country. Several Christian kingdoms pushed the Arabs south, finally reconquering the last remnant of the Caliphate of Al-Andalus in 1492. There had been collaboration as well as conflict. But the victorious and dogmatic Catholics ordered first the forcible conversion of Jews and Muslims and, eventually, their expulsion. Since the early 17th century Spain has been, officially at least, a monolithically white Christian country.

Until recently. In the past decade some 5m immigrants have arrived in Spain. In all, 12% of the population is now foreign-born, up from 3% in 1998. During that period Spain has absorbed more immigrants than any other country except the United States. Some 700,000 of those foreigners are sun-seeking Britons, and there are many Germans too. But most of the new arrivals come from poorer countries. Moroccans tend the sunloungers on the beaches and toil on building sites alongside Bulgarians and Romanians. Ecuadoreans and Bolivians work in the plastic greenhouses of Almería and in domestic service. Cubans and Dominicans help out as carers. Black African street vendors hawk bags and flowers.

Spain has so far lived in harmony with these newcomers. It helps that most Spanish families remember the time from the 1950s to the 1980s when at least one of their members emigrated to find work. It helps, too, that around 1.5m of the newcomers are Latin Americans. “History, language and similarity of culture have all eased integration,” says Raúl Jiménez of the Rumiñahui Association, a group that helps Ecuadorean migrants. But Spain now also has 1.1m Muslims. Mosques are in use in Granada again for the first time in 500 years. Despite the Islamist bombings of 2004 there has not been an outburst of Islamophobia. The Muslims in Spain are “exceptionally moderate and well-integrated”, according to Mr Rubalcaba, the interior minister. However, since the bombings the ministry has rounded up a few radical groups involved in recruiting and fundraising for al-Qaeda.

What has also eased absorption is that successive governments have granted amnesties to a total of 1.2m illegal immigrants, bringing them out of the black economy. Moreover, Spain’s welfare state is newer than those of other western European countries and there is less of a sense that immigrants are straining public services (though in schools they are). Spaniards also know that the social-security system has been saved from actuarial insolvency by the contributions of young immigrants.

According to Mr Jiménez, the newcomers have generally been treated well, but he and many others worry that rising unemployment will bring intolerance. There have always been isolated cases of attacks on immigrants, and recent months have seen a slight increase. Over the past year both the main parties have toughened their policy. Mr Rajoy campaigned against Mr Zapatero’s amnesty, and the government has taken more energetic steps to prevent illegal immigration. It has also unveiled a scheme to allow migrants to draw their unemployment insurance as a lump sum if they return to their home country and renounce their residence rights in Spain. Nobody expects many takers.

Economist.com SPECIAL REPORTS

The Spanish legion

Nov 6th 2008
From The Economist print edition

Modern Spain has bred a remarkable range of successful companies

FRANCO was still alive when your correspondent first visited Madrid. Ensconced in the centre of the *meseta*, it had the sleepy air of a compact provincial town of bureaucrats. In the subsequent decades, perhaps nowhere else in western Europe has changed so dramatically. Madrid is now a sprawling metropolis of office parks and housing developments stretching north and west towards the distant Sierra de Guadarrama, all linked by a spaghetti bowl of motorways and a metro that has more than doubled in size. It is here that you find many of the new Spanish multinationals.

On a 150-hectare (375-acre) site beside the outermost of Madrid's three ring roads at Boadilla del Monte, Banco Santander has built a new headquarters. With its low buildings set in parkland beside a golf course and groves of old olive trees, it has the air of an American university campus. It is a statement about how far Santander has come and where it wants to go. In three decades Emilio Botín, the chairman, has turned an obscure provincial bank into Europe's second-largest, behind HSBC.

Reuters



Banking on Botín

For its first forays abroad, back in the early 1990s, Santander chose Latin America. It subsequently moved into Britain, buying Abbey in 2004. Mr Botín's dealmaking has been shrewd. When last year he joined two other banks in buying ABN AMRO, a Dutch financial group, he walked off with the best bits. The deal turned Santander into the third-biggest bank in Brazil, and months after acquiring ABN's Italian operation Mr Botín sold it for €3.4 billion more than he paid for it.

In this year's carnage Santander has been pecking at banking carrion. It snapped up one troubled British mortgage lender, Alliance & Leicester, and the deposit book of another, Bradford & Bingley. It bought Sovereign Bancorp, an American bank, for a seventh of the price it paid per share for a minority stake in 2005. Mr Sáenz says that the bank is receiving many offers: "Every day they're bringing up corpses in carts. We have to be very cool-headed." The group is "happy" with its current 50-50 split between emerging and developed markets, but the growth priority is continental Europe. "Our home market isn't Spain, it's the euro area," he says.

Mr Sáenz attributes Santander's success to three things. The first is "excellent execution", which includes its computer systems but also good management of costs, people and risks. The second is its decision to stick to commercial banking instead of going for riskier ventures. And third, "we haven't made big mistakes" in acquisitions. There were some errors, such as buying a bank in Argentina before the 2001 collapse and a flirtation with investment banking in the 1990s, says Mr Sáenz. But those do not amount to much: "We don't follow fashion."

The combination of international ambition and risk-aversion is characteristic of Spanish business. It is complemented by a dash of herd behaviour. Most of the Spanish multinationals began their international expansion in Latin America in the 1990s, with encouragement from Felipe González. Having often overpaid there to start with, they have made big profits in the past few years. In the past month, however, worries about Latin America have hit the share prices of some Spanish firms.

For several, the next stop was Britain (Telefónica acquired O2, a mobile operator; Ferrovial, perhaps ill-advisedly, bought BAA, an airports operator; and Iberdrola, a power company, bought Scottish Power). Others are expanding in continental Europe: NH, a hotel group, bought Golden Tulip, a Dutch chain, and Italy's Jolly hotels; Planeta, a Barcelona publishing and media group, this year bought Editis, a big French educational publisher, for €1 billion.

Many are starting to look to Asia and the United States (BBVA has stakes in banks in both places).

Repsol's boss since 2004, Antonio Brufau, is restructuring the company after his predecessor's costly bet on Argentina with the purchase of YPF in the 1990s. Mr Brufau has sold a quarter of YPF to a local investor and is slowly expanding Repsol's portfolio of oil and gas assets, concentrating on the Gulf of Mexico, the Caribbean and north Africa.

If in doubt, specialise

The second big change has involved branching out into new and more sophisticated businesses. That is particularly true of family-owned construction companies, some of which saw the property bust coming. Ferrovial has become a specialist infrastructure operator, drawing on Spain's long tradition of turning out good road engineers. Acciona is trying to become a world leader in renewable-energy technology. Three years ago construction accounted for 80% of the firm's business; now it makes up only 40%. The rest comes from electricity, renewable energy and water-desalination projects. That transformation is the work of José Manuel Entrecanales, whose grandfather founded the company.

Eyevine





The answer is blowing in the wind

Mr Entrecanales engineered a dawn raid in which he bought 26% of the shares in Endesa, Spain's electricity giant. Endesa faced a hostile bid from Germany's e.ON which the Spanish government wanted to block—a stance for which it was later criticised by the European Commission. Mr Entrecanales insists he was motivated by business considerations, not politics: "It was a political battle in which I was in the middle." Certainly the deal was good business. Italy's ENEL bought 67% of Endesa's shares, but the agreement provides for Acciona to manage Endesa and to have the right any time after 2011 to withdraw with its choice of either one-third of the assets or cash. Endesa has also given Acciona electricity know-how and higher "visibility", says Mr Entrecanales.

But he has larger ambitions: in ten years' time he wants Spain to account for just 30% of Acciona's business, against 80% now. He is shedding non-core assets (a funeral business, some motorway operations and parking lots) and aiming to build a company making high returns from "technologically complex" renewables, engineering and desalination projects.

Many Spanish multinationals operate in regulated industries. Spanish business has long been close to power. Its foreign buying spree was spurred by an accounting rule that allowed businesses to write off the cost of acquisitions against tax—a loophole closed after the European Commission ruled that it amounted to illegal state aid. But it is also true that some Spanish companies are becoming world-beaters. They often base their success on technology and effective use of computer systems. The best-known example is Inditex, the owner of Zara and other clothing shops, whose systems allow it to get clothes into its stores faster than rivals can. Abel Linares of Oesía, a software firm, argues that Spanish firms were lucky because new technology arrived just as their country was entering the EU; many of them bought more up-to-date equipment than competitors abroad.

Behind the front rank of Spanish multinationals is a second cohort of medium-sized businesses that are following in their globetrotting footsteps. Many of these are little-known industrial firms scattered around the country. "There is a Spanish *Mittelstand*," says Mr Canals of IESE. An example is Viscofan, a Pamplona-based producer of man-made casings for sausages and other meat products. Six of its seven factories are outside Spain, as are more than 80% of its sales of €506m. It makes the casings for two-thirds of the hot dogs sold in America, and for a large proportion of English breakfast sausages. Its business involves much research and technology. The firm is now developing collagen products for medical and dental use, says José Antonio Canales, its chief executive.

Oesía, launched in 2000, is now Spain's second-biggest software company, with sales forecast at €220m this year. It writes specialist software for several of the Spanish multinationals but aims to become more international, starting with the Spanish operations of European multinationals. It already has software factories in Brazil, Cuba, Colombia and Mexico, partly because its Spanish clients are there.

Felix Solís Avantis, a family company that is Spain's biggest maker of still wine and the world's tenth-biggest winemaker, has also branched out abroad. It has wineries in eight different wine-producing regions, including La Rioja and Ribera del Duero, and sells in 85 countries. Exports accounted for 44% of its sales of €144m last year, up from a third a decade ago.

Many Spanish companies are now well-capitalised, with good technology and a cadre of managers with international experience. These are important assets as recession looms. They also have another point in their favour: the Spanish language. Mr Linares, for example, says he sees it as a competitive advantage for Oesía. It makes it harder for rivals such as Accenture or Capgemini to poach his Latin American software engineers. So it is ironic that politicians in some parts of Spain are now doing their best to discourage the use of a language spoken by 420m people, more than any other except English, Mandarin Chinese and Hindi.

The perils of parochialism

Nov 6th 2008
From The Economist print edition

Europe is no longer an automatic solution for Spain's ills. But nor is navel-gazing

SPANISH companies may be going global. The AVEs and the motorways may have shrunk Spain from a vast country that only a generation ago took days to traverse. But paradoxically many Spanish politicians seem to find it increasingly hard to look beyond their own region, let alone their own country. That imposes costs, both tangible and intangible.

Mr González and Mr Aznar, in their different ways, had ambitions for Spain to play a role in the world. Mr González built up links between Spain and Latin America and made it a serious presence in the EU. Mr Aznar, sensing that Europe's centre of gravity was moving east, tried to establish a special relationship with the United States. That had a certain logic, even if he failed to persuade Spaniards of it. It has been harder to divine the international ambitions of Mr Zapatero, who apart from Spanish only speaks a little French and has never spent much time outside Spain. He has said that he will give greater weight to foreign policy in his second term. He argues that Spain is uniquely well-placed to promote "north-south dialogue". His main initiative has been to call for an "alliance of civilisations", but few countries have paid more than lip-service to this.

Perhaps his one concrete achievement in foreign policy has been in Africa. His government has offered aid to several north-west African countries if they will take back illegal immigrants deported from Spain. Some 80% of illegal migrants detained in Spain are now returned to their country of origin.

Mr Zapatero has raised spending on foreign aid from 0.25% of GDP in 2004 to 0.5% this year, so his efforts in Africa have not come at the expense of Latin America (where Spain spends €1.5 billion a year). Both the United States and the rest of Europe like to talk regularly to Spain about Latin America, says Trinidad Jiménez, who is in charge of relations with the region.

Generations of Spaniards believed with José Ortega y Gasset, an early-20th-century philosopher, that "Spain is the problem, Europe is the solution." Having done so well out of the EU, Spain has uncritically supported almost anything coming out of Brussels. But from 2013 it will become a net contributor to EU funds, which may change its attitude. In the first half of 2010 it will hold the EU presidency, which Miguel Angel Moratinos, the foreign minister, says it will use to get Europe to try harder on innovation and research and development.

That sounds like a continuation of the Lisbon Agenda pushed by Mr Aznar, though Mr Zapatero has seemed keener on the (unrelated) Lisbon Treaty, which strengthens the Brussels institutions. Indeed, the country has yet to debate its interests in Europe properly. "We need to work out what we want to say and not just demand the right to speak," says Mr Pérez Díaz, the Madrid sociologist.

Defending the idea of Spain

That requires a clearer sense of what Spain is and what it stands for. In some ways, localism is one of its strengths: for example, the attachment of Spaniards to the folklore and festivals of their home towns is an attractive part of their culture. But exaggerated localism is becoming a weakness. In the past teachers and other public servants would move around the country. Now they stay in their own region. Some companies find it difficult to recruit managers who are prepared to work abroad.

Reversing the drift to localism requires changing the terms of the political debate. It would help to take another look at the constitution now that it is turning 30. This charter has given Spain, for the first time in its history, a precious combination of democracy and political stability. But it has a few flaws, which are becoming more apparent. Some amendments would be timely. Formally embracing federalism would do more than anything else to answer the regional question. The electoral system gives disproportionate weight to small nationalist parties. Adding seats elected on a national basis would make it fairer.

In the past few years Spain's political leaders have chosen to look backwards and to emphasise the local issues that divide them. Recession will create new and different political demands. Spain will no longer be able to look to Europe for further windfalls. The euro has brought benefits but also a loss of competitiveness. For the first time since Ortega coined his analysis, Europe is not an automatic—and relatively painless—solution to Spain's problems. A return to rapid growth and high employment demands an economy that is even more outward-looking, and a national government capable of pushing through unpleasant reforms. That in turn requires the politicians to defend the idea of Spain more effectively even as they give due recognition to their country's regional diversity. After all, over the past 30 years few other places have been as successful.

Sources and acknowledgments

Nov 6th 2008

Acknowledgments:

Apart from those mentioned in the text, the author would like to thank the many other people who helped in various ways with the research for this special report. He is particularly grateful to Eduardo Serra Rexach, Bernadino León, Ana Patrícia Botín, Maite Rico, Luis Prados de la Escosura, Pedro Ruíz Morcillo, Tom Burns Marañón, Lord (Tristan) Garel-Jones, Martin Leeburn, Juan Cierco and Fernando Villalba.

Sources:

Barton, Simon. “A History of Spain”, Palgrave Macmillan, 2004.

Carr, Raymond (editor). “Spain: A History”, Oxford University Press, 2000.

Chislett, William. “Spain: Going Places, Economic, Political and Social Progress 1975-2008”, Telefónica, 2008; and “The Zapatero Government and Spain’s March 9th Election”, unpublished paper.

Elliott, J.H. “La España de Ayer y de Hoy”, unpublished paper.

Encarnación, Omar G. “Reconciliation After Democratization: Coping with the Past in Spain”, Political Science Quarterly, Vol 123, No 3, Fall 2008.

Hooper, John. “The New Spaniards”, Penguin, 2006.

Kamen, Henry. “The Disinherited: Exile and the Making of Spanish Culture 1492-1975”, HarperCollins, 2007; and “Imagining Spain: Historical Myth and National Identity”, Yale University Press, 2008.

Magone, José M. “Contemporary Spanish Politics”, Routledge, 2004.

OECD Economic Surveys: Spain, Volume 2007/1, January 2007, OECD.

Savater, Fernando et al. “Política razonable”, Editorial Triacastela, 2008.

Tremlett, Giles. “Ghosts of Spain: Travels Through a Country’s Hidden Past”, Faber and Faber, 2006.

Tussell, Javier. “Spain: From Dictatorship to Democracy”, Blackwell, 2007.

Woodward, Paddy. “The Basque Country: A Cultural History”. Signal Books, 2007.

Offer to readers

Nov 6th 2008
From The Economist print edition

Buy a PDF of this complete special report, including all graphics, for saving or one-click printing.

The Economist can supply standard or customised reprints of special reports. For more information and to place an order online, please visit our Rights and Syndication website.

Clean technology in the downturn

Gathering clouds

Nov 6th 2008
From The Economist print edition

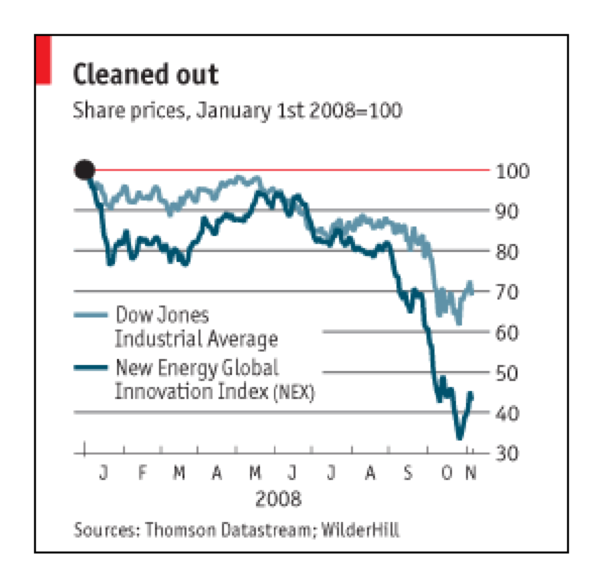
The economic slowdown casts a shadow over the prospects for clean technology

Eyevine



EARLIER this year, with the oil price at record heights, T. Boone Pickens, a celebrated Texas oilman, seemed to confirm the unstoppable growth of the clean-technology industry when he announced plans not only to build the world's biggest wind farm, but also to spend $58m of his personal fortune promoting the cause of wind power. On October 30th, with oil prices having fallen by more than half, he told a television reporter that the boom he had foreseen in wind would be "put off", due to the unexpected fall in the price of fossil fuels and the sudden difficulty of borrowing money.

Mr Pickens is not the only clean-tech investor caught out by the credit crunch. New Energy Finance, a research firm, calculates that the amount of project finance devoted to clean-energy projects around the world fell by almost 25% in the third quarter, to $18 billion. The firm expects it to fall further before the end of the year. It also expects firms to raise less money on stockmarkets, due to the financial turmoil. NEX, an index that tracks clean-tech stocks globally, has tumbled even faster than the market as a whole (see chart).



Big American utilities are slashing their investments in alternative energy. Florida Power & Light has cut its planned investment in wind power next year by 400 megawatts. Duke Energy of North Carolina has lopped $50m off its budget for solar power. And on October 31st VeraSun Energy, one of America's biggest ethanol producers, caught out by gyrations in the prices of corn and petrol (gasoline), filed for Chapter 11 bankruptcy protection. In the European Union the price of carbon permits has fallen from a high of almost €30 in July to around €20, making clean-tech investments less attractive.

But Michael Liebreich, the boss of New Energy Finance, expects total investments in clean energy to fall only slightly in 2008, thanks to a strong performance in the first part of the year. Venture-capital and private-equity investments actually rose slightly in the third quarter. The price of oil aside, he says, the issues that stoked interest in clean tech, including global warming and energy security, are as prominent as ever.

A few customers for wind turbines, says Steve Bolze of GE Energy, are delaying their orders, but the firm has no doubts about the industry's long-term prospects. The world still needs energy, argues Steve

Sawyer, the head of the Global Wind Energy Council, an industry group, and even if banks are slower to lend, utilities can often afford to pay for new generation out of their own revenues. Investing in dirtier sources of power carries risks of its own, he adds, as illustrated by the recent see-sawing in the price of fossil fuels.

Moreover, a new rationale for promoting green investments is beginning to emerge. Many luminaries, from the head of the United Nations Environment Programme to Barack Obama, America's president-elect, tout the industry as a means both to address global warming and stimulate flagging Western economies. Reports enumerating the economic benefits of state support for clean technology, in the form of industries fostered and jobs created, abound (although few of them examine the potential costs of such schemes, in the form of increased government debt and misallocated capital). American lawmakers, at any rate, seem convinced: they slipped an extension of all-important subsidies for renewable energy into the recent bail-out for financial services.

Clean-tech firms with strong business models can still raise money. EDF Energies Nouvelles, the renewable-energy firm controlled by Europe's biggest utility, recently raised $734m from a secondary share issue. GridPoint, an American start-up which sells technology to improve the efficiency of electrical grids, raised $120m in venture capital in September; Silver Spring Networks, another smart-grid firm, raised $75m last month. In general, firms selling technology that will earn a quick return, in fields such as energy efficiency, are proving most resilient. Capital-intensive businesses such as ethanol distilleries are struggling—especially Brazilian ones whose debts are in dollars while their revenues come in depreciating reais.

Makers of wind turbines and solar panels still have long waiting-lists for their wares, so a slowdown is not as alarming as it sounds, Mr Liebreich points out. Smaller manufacturers with weaker balance-sheets will be snapped up by bigger, more efficient firms, he predicts, and shortages that have crimped the industry's growth will ease. The price of silicon, the chief component of photovoltaic cells, is already falling. Cheaper steel and copper should help reduce the cost of making wind turbines. A shortage of capital may become a new bottleneck, he says, but it will not kill off the industry any more than the previous ones did.

Business in Japan

Criss-crossed capitalism

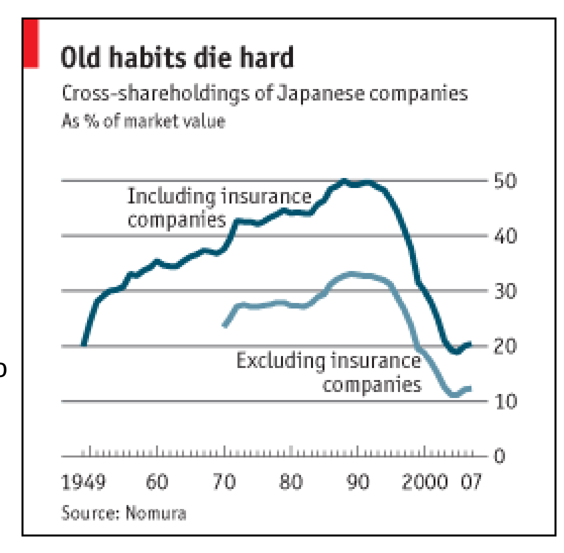
Nov 6th 2008 | TOKYO
From The Economist print edition

Japanese firms' tradition of cross-shareholdings is causing problems

WHEN Japanese shares plunged to a 26-year low on October 27th, it was not just investors who felt the pain. Billions of dollars of corporate assets were also wiped out because many Japanese companies own stakes in their peers. Cross-shareholdings (when two firms hold each other's shares) and stable-shareholdings (friendly firms holding shares they almost never sell) are the blood-brotherhood of corporate Japan. Such holdings are regarded as a way to cement business relationships, rather than as investments.

After falling for a decade, the level of cross-shareholding has crept up since 2004 (see chart). Greater shareholder activism, mostly on the part of foreign investors, and fear of hostile takeovers prompted managers to adopt mutual shareholdings to insulate themselves from nettlesome outsiders. Over 20% of the shares on the Tokyo Stock Exchange are owned by Japanese companies and financial groups.

The practice is most common in traditional industries such as steel, paper and energy. But big global carmakers and electronics firms participate as well. Toyota, Honda and Nissan are all involved in webs of interlocking shareholdings with their business partners and suppliers. In 2007 Toshiba and Sharp bought stakes in each other, as did Sharp and Pioneer. Panasonic, which is considering taking a controlling stake in Sanyo, held shares in over 300 companies as of March 2008, valued at ¥446 billion (around $4 billion).



The practice originated in 1952, when someone tried to take over what is today Mitsubishi Estate, a huge property firm tied to the famous trading house. In response, 11 companies linked to Mitsubishi bought shares to block the outsider. In the 1960s, when foreigners began buying shares after Japan liberalised its financial markets, cross-shareholdings were adopted as a defensive measure. By 1989 more than half the stockmarket was tied up in this way.

Cross-holdings cement alliances, but also make firms captive to their partners. They make it harder to work with firms outside the circle, reinforcing the inflexibility of Japan's business environment. As share prices fall, cross-holdings amplify the pain. When the Nikkei-225 Stock Average fell around 10% last year, firms booked latent losses of ¥444 billion. Between March and September, corporate shareholdings wiped ¥330 billion in value from more than 160 public firms.

This punishes companies, even though their actual business remains unchanged. "Write-downs on unrealised losses are far more than an accounting blemish—they are a direct hit to earnings on the income statement, and reduce assets and shareholder equity on the balance-sheet," says Steven Towns, a Japanese-equities specialist. Companies' credit ratings may also suffer, increasing their borrowing costs.

The most visible impact is in financial services. Banks need to recalculate the value of their assets daily, since the shareholdings are part of the core capital they lend against. When shares hit a trough last month, Japan's three "megabanks" wrote down around $12 billion in paper losses from some $120 billion in shareholdings. Their capital ratios fell by half a percentage point, putting the banks in uncomfortable territory. The result was a scramble to recapitalise. Japan's biggest bank, Mitsubishi UFJ Financial Group, considered raising $10 billion, just two weeks after buying 21% of Morgan Stanley for $9 billion. Others are considering similar moves. To ease the burden, the government has proposed relaxing accounting rules and buying the shares from the banks (as it did in 2002 to address Japan's banking crisis).

Corporate shareholding is also a bone of contention for foreigners investing in Japan. Steel Partners, an American fund with stakes in two dozen Japanese firms, wrote last month to the management of Ezaki Glico, a confectionery company, noting that the firm's cross-shareholdings had erased some $50m in value. "Management is responsible for running a food company, not an investment portfolio," wrote Steel's boss, Warren Lichtenstein. An unwinding of cross-holdings by J-Power, the former state-owned energy giant, was one of the demands made by the Children's Investment Fund (TCI), which amassed a 9.9% stake in the company starting in 2005. Rebuffed, TCI has just abandoned its investment in J-Power with a $130m loss.

Japanese bosses say cross-holdings are an aspect of their business culture that will endure, however much foreigners object. "It disembowels corporate governance," retorts Nicholas Benes, the head of JTP, a merger-advisory firm. Almost 50% of voting rights in Japanese firms are controlled by 2.1% of shareholders, he notes. Because banning the practice is impossible, he wants regulators to require that firms at least disclose their stakes, so that transparency can help investors press managers to use their company's capital more wisely.

Motorola and Sun

Icons no more

Nov 6th 2008
From The Economist print edition

Two once-mighty technology firms need to take radical measures

"HAVE lunch, or be lunch." The Silicon Valley mantra coined by Scott McNealy, the outspoken former boss of Sun Microsystems, a troubled computer-maker, still rings true as the technology industry heads into recession. At particular risk of being lunch are Sun and another once-mighty technology firm: Motorola, America's ailing telecoms-equipment giant. Both posted dismal results on October 30th. Sun's sales to Wall Street firms, which are among its biggest customers, fell by 20% in the most recent quarter compared with a year earlier, and it reported a loss of $1.68 billion. Sales at Motorola, meanwhile, fell by 15%, with unit sales of mobile phones down by a third, and a loss of $397m. Yet even before the downturn, both firms were in serious trouble.

Sun styled itself "the dot in .com" during the internet boom, selling fancy servers to firms rushing to set up online. Motorola's most recent claim to fame was its hugely popular RAZR (pronounced "razor") handset, the first version of which appeared in 2004. But both companies focused too much on their clever hardware, and too little on software and services. Today Sun accounts for 11.8% of server sales (by value) worldwide, compared with 18.1% in 2000. Motorola's share of the handset market has dropped from 22.4% at the height of RAZR mania to 9.5% in the second quarter of this year.

Both firms hope open-source software, developed by volunteers and distributed free online, will help them make a comeback. Sun has released an open-source version of its Solaris operating system and bought several open-source firms, notably MySQL, a database-maker. Motorola is building "smart" phones based on Android, an open-source operating system developed by Google, the internet giant.

Investors seem unconvinced. Both companies' shares have fallen even further than the rest of the market. Sun's share price has fallen from nearly $24 in October 2007 to below $5; Motorola's has fallen from nearly $20 to below $5. Both firms have a stockmarket value of less than one-third of their annual sales, prompting suggestions that they should go private.

Something radical is certainly required. One idea comes from AMD, another embattled American technology firm. Last month the chipmaker said it would spin off its factories into a separate company in which an investment firm, set up by the government of Abu Dhabi, would invest at least $2.1 billion, making it the majority owner. This will allow AMD to focus on designing chips. For Abu Dhabi it is part of a diversification away from oil.

Sun and Motorola do not need cash that badly, and it is unclear whether Abu Dhabi or other cash-rich countries would be interested in either of them. But Sun may be forced to spin off part of its business. In recent months Southeastern Asset Management, an investment firm, has bought more than 20% of Sun with the aim of unlocking its value. Sun could sell off its hardware business, perhaps to Fujitsu, a Japanese firm, and focus on providing new "cloud computing" services.

As for Motorola, it said in March that it would split off its mobile-phone division, creating two listed companies. But these plans have now been put on hold until the unit's problems have been fixed, which is expected to take until 2010. Might it make more sense to let someone else clean up the mess, perhaps Huawei or ZTE, China's rising telecoms-equipment giants?

The troubles of these three titans suggest that the technology industry will look different after the recession. Open-source software will play a bigger role. Hardware-makers will have consolidated. And more of the industry will reside outside America, at least financially. In short, the recession will help the industry mature.

Transport in Italy

Trains v planes

Nov 6th 2008 | ROME
From The Economist print edition

The revived Alitalia will face growing competition

APPARENTLY at ease with risk, the businessmen and bankers who are investing in the phoenix-like rebirth of Alitalia submitted an offer for the airline's assets to the bankrupt flag-carrier's administrator on October 31st, even after failing to convince pilots and cabin crew to sign new contracts. But although fuel costs have fallen lately, the outlook for aviation has worsened. The economic slowdown is weakening demand. And now fierce competition is threatening the airline's services between Rome and Milan—a core part of its business.

On November 3rd easyJet, one of Europe's leading low-cost operators, began operating four flights a day from Fiumicino, Rome's main airport, to Malpensa, Milan's second airport. But an even greater danger to a reborn Alitalia may be that posed by trains. Allowing for journeys to and from the airports and the time needed for check-in, security and boarding, a trip from central Rome to central Milan by plane takes well over three hours. The quickest train takes just over four hours. But on December 15th a 182km (114 mile) section of new track will open between Bologna and Milan, cutting the journey time by about half an hour. And at the end of next year 79km of high-speed track between Florence and Bologna should enter service, reducing the one-hour travel time between the two cities by almost half.

Moreover the threat does not just come from Trenitalia, the state-owned rail operator. Last month Nuovo Trasporto Viaggiatori (NTV), a private-sector operator headed by Luca di Montezemolo, Ferrari's boss, revealed plans to operate high-speed trains between cities including Rome, Milan, Turin and Venice, starting in 2011, with 13 trains a day between Rome and Milan.

Mr di Montezemolo is sure he and his fellow investors are on to a winner. "Italy is a country made for high-speed trains. There is nothing to be gained from investing in airlines," he says. Intesa Sanpaolo, Italy's biggest bank, which owns 20% of NTV, agrees with him—up to a point. It is hedging its bet with a large stake in the firm resurrecting Alitalia.

Blogging

Oh, grow up

Nov 6th 2008 | SAN FRANCISCO
From The Economist print edition

Blogging is no longer what it was, because it has entered the mainstream

IN THE anthropologically isolated subculture of elite bloggers, it was the equivalent of a watershed, and certainly a tear-shed. With “a heavy heart, and much consideration”, Jason Calacanis this summer announced his “retirement from blogging”, which he believed was “the right decision for me and my family”. Mr Calacanis, a founder of Weblogs, Inc., a blog network that he later sold to AOL, an internet portal, had been a member of the “A-list”—those bloggers with the most incoming links and the highest “authority” on blog-search engines such as Technorati. With the bathos of Napoleon departing for Elba or Michael Jordan bidding adieu to basketball, Mr Calacanis bowed out, reverting to the ancient medium of e-mail to disseminate his opinions.

“Blogging is simply too big, too impersonal, and lacks the intimacy that drew me to it,” he offered by way of explanation. It was, he said, “the pressure” of staying on the A-list—ie, of keeping his blog so big and impersonal—that got him. Only a few years ago, so few people blogged that being a blogosphere celebrity required little more than showing up. Now it takes hard work. And vitriol. “Today the blogosphere is so charged, so polarised, and so filled with haters hating that it’s simply not worth it,” Mr Calacanis lamented.

The rest of the world may well have missed the unfolding of his tragedy. Behind it, however, is a bigger trend. Blogging has entered the mainstream, which—as with every new medium in history—looks to its pioneers suspiciously like death. To the earliest practitioners, over a decade ago, blogging was the regular posting of text updates, and later photos and videos, about themselves and their thoughts to a few friends and family members. Today lots of internet users do this, only they may not think of it as blogging. Instead, they update their profile pages on Facebook, MySpace or other social networks.

They may also “micro-blog” on services such as Twitter, which recreate the raw, immediate and intimate feel of early blogs. Twitter messages, usually sent from mobile phones, are fewer than 140 characters long and answer the question “What are you doing?” Tellingly, Evan Williams, the co-founder of Blogger—an early blogging service that is now owned by Google, the Wal-Mart of the internet—now runs Twitter, which he regards as the future.

As for traditional (if that is the word) blog pages, these tend increasingly to belong to conventional media organisations. Nearly every newspaper, radio and television channel now runs blogs and updates them faster than any individual blogger ever could. Professional blogs such as HuffingtonPost.com for liberals (with 4.5m visitors in September) or FreeRepublic.com for conservatives (with 1m visitors in that month) have played a big role in America’s election season, according to comScore, an online-measurement firm. These “new media” firms are now suffering from the same advertising slowdown as their offline rivals. Gawker, a gossip-blog empire, has already begun laying off bloggers.

Simultaneously, companies far outside the media industry have embraced blogging as just another business tool. They are using blogs both to get corporate messages to the public and as an internal medium for staff. Companies like Six Apart, which provides Movable Type, TypePad and other blogging tools, see firms as their most promising market.

Gone, in other words, is any sense that blogging as a technology is revolutionary, subversive or otherwise exalted, and this upsets some of its pioneers. Confirmed, however, is the idea that blogging is useful and versatile. In essence, it is a straightforward content-management system that posts updates in reverse-chronological order and allows comments and other social interactions. Viewed as such, blogging may “die” in much the same way that personal-digital assistants (PDAs) have died. A decade ago, PDAs were the preserve of digerati who liked using electronic address books and calendars. Now they are gone, but they are also ubiquitous, as features of almost every mobile phone.



Transport in Italy

Trains v planes

Nov 6th 2008 | ROME
From The Economist print edition

The revived Alitalia will face growing competition

APPARENTLY at ease with risk, the businessmen and bankers who are investing in the phoenix-like rebirth of Alitalia submitted an offer for the airline's assets to the bankrupt flag-carrier's administrator on October 31st, even after failing to convince pilots and cabin crew to sign new contracts. But although fuel costs have fallen lately, the outlook for aviation has worsened. The economic slowdown is weakening demand. And now fierce competition is threatening the airline's services between Rome and Milan—a core part of its business.

On November 3rd easyJet, one of Europe's leading low-cost operators, began operating four flights a day from Fiumicino, Rome's main airport, to Malpensa, Milan's second airport. But an even greater danger to a reborn Alitalia may be that posed by trains. Allowing for journeys to and from the airports and the time needed for check-in, security and boarding, a trip from central Rome to central Milan by plane takes well over three hours. The quickest train takes just over four hours. But on December 15th a 182km (114 mile) section of new track will open between Bologna and Milan, cutting the journey time by about half an hour. And at the end of next year 79km of high-speed track between Florence and Bologna should enter service, reducing the one-hour travel time between the two cities by almost half.

Moreover the threat does not just come from Trenitalia, the state-owned rail operator. Last month Nuovo Trasporto Viaggiatori (NTV), a private-sector operator headed by Luca di Montezemolo, Ferrari's boss, revealed plans to operate high-speed trains between cities including Rome, Milan, Turin and Venice, starting in 2011, with 13 trains a day between Rome and Milan.

Mr di Montezemolo is sure he and his fellow investors are on to a winner. "Italy is a country made for high-speed trains. There is nothing to be gained from investing in airlines," he says. Intesa Sanpaolo, Italy's biggest bank, which owns 20% of NTV, agrees with him—up to a point. It is hedging its bet with a large stake in the firm resurrecting Alitalia.

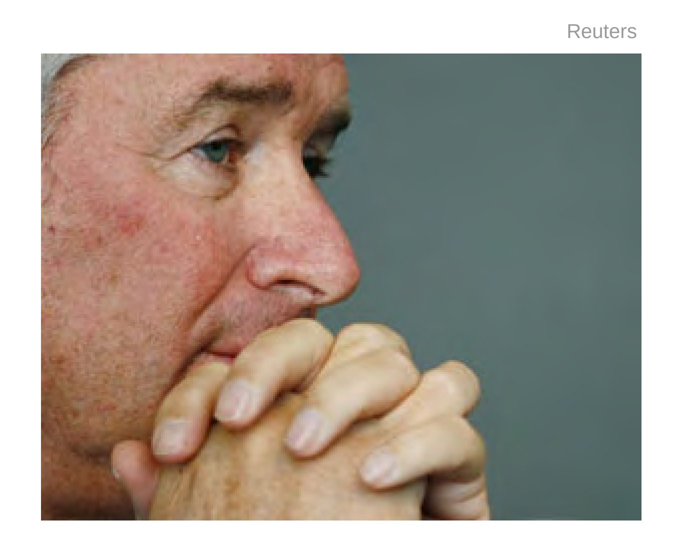
Face value

Raging bull

Nov 6th 2008
From The Economist print edition

Steve Schwarzman declares the dawn of a new golden age for private equity

Reuters



“I’M NOT Robert de Niro, but I’m a raging bull on private equity,” enthused Steve Schwarzman on October 28th. And, lest his strikingly contrarian message be lost on the mostly worried investors gathered at the North American Venture Capital Summit in Canada, the co-founder of the Blackstone Group described this as a “wonderful, wonderful time to be an investor”, an “opportunity now of enormous proportions” in which “it is very easy to make money” and “you basically can’t lose.”

Economic gloom is spreading throughout the world, and many of his fellow financiers are fighting to preserve their shrinking fortunes, including two rival private-equity giants: Kohlberg Kravis Roberts (KKR), which has again postponed its initial public offering (IPO) due to difficult market conditions, and the Carlyle Group, which this week told investors not to expect returns on their money any time soon. Yet Mr Schwarzman’s exuberance is of the rational kind—which doubtless makes it all the more galling to his many critics. The severity of the pain felt by others in the financial system is what is creating desperate sellers—and thus the glorious investment opportunities that could ultimately make Mr Schwarzman and his investors richer than ever.

As the old saying goes, the best time to invest is when there is blood in the streets (in this case, Wall Street). And unlike many of his erstwhile rivals, Mr Schwarzman still has plenty of cash to invest. Blackstone closed a record $21 billion fund just as the credit crunch began in August 2007, and has reportedly raised the first $9 billion of a new fund already this year. Though debt is scarce for most deals, meaning Blackstone must risk more of its equity, it has been preparing for a downturn, for example by buying a hedge fund with expertise in stressed debt.

When Warren Buffett urges ordinary investors to buy shares, as he did the other week, after negotiating highly favourable terms for his own firm for valuable stakes in companies such as Goldman Sachs and GE, he is praised for his sage leadership. By contrast, although Mr Schwarzman may have an even better case to make, he lacks Mr Buffett’s power to charm. Instead, his speeches often earn him epithets such as “self-serving”, “arrogant”, and “too cocky by half”. A blogger on peHUB, an online forum for private-equity types, described Mr Schwarzman’s upbeat message in Canada as “either one of the laziest keynote speeches I have ever seen, or one of the most condescending”.

Mr Schwarzman may be right to say that pointing out the existence of a silver lining to the very dark cloud shrouding the global economy is “actually meant to be uplifting, in a twisted financial way”. But such “making money is easy” comments could also help him regain the title of “Wall Street Titan the Public Loves to Hate”. He lost it only recently to Dick “the Gorilla” Fuld, who presided over the bankruptcy

of Lehman Brothers in September. (Mr Schwarzman began his career at Lehman, but, as he quipped last week, he "got out…at the right time".)

For most of the 23 years since he founded Blackstone with Pete Peterson, Mr Schwarzman prospered largely unnoticed by the public, who if they knew anything at all about private equity, associated it with Henry Kravis of KKR. Mr Kravis's notorious hostile takeover of RJR Nabisco has just been commemorated with a 20th anniversary edition of the bestselling book about it, "Barbarians at the Gate". Mr Schwarzman's image problems became serious only when he turned 60, and paid Rod Stewart a reported $1m to help him celebrate. Even though this was dwarfed by the sum reportedly paid by another private-equity chief, David Bonderman, to his 60th birthday party entertainers, the Rolling Stones, Mr Schwarzman's party gave the press the opportunity to run lots of articles about his expensive homes and lavish tastes.

Things got worse when the prospectus for the IPO of shares in Blackstone drew attention to the favourable tax treatment typically given to private-equity firms, prompting a frenzied attack on the industry by politicians around the world. (However, thanks to some astute negotiations between Mr Schwarzman and the SEIU, an influential trade union, when proposals for tougher taxation of private equity make their way through Congress next year, as they surely will, the "offenders" mentioned most often by politicians will probably be Blackstone's rivals at KKR.)

Calculated optimism

On October 27th Blackstone's share price dropped to $7, its lowest since the firm's IPO in June 2007 and one-fifth of its peak last year. Its third-quarter results, released on November 6th, were disappointing, largely owing to the lack of opportunities to sell firms in its portfolio because of the freeze in the financial markets. By highlighting the lucrative long-term investment opportunities available, perhaps Mr Schwarzman hoped to boost the flagging share price, and encourage pension funds and wealthy individuals to invest in his new fund. Happily for Mr Schwarzman, the Chinese government recently decided to raise its shareholding in Blackstone, despite the plunge in the value of its investment.

Whether his optimism proves to be justified may depend on how quickly the leading economies get back on their feet—and whether this happens before serious damage is done to some of the indebted companies in Blackstone's portfolio. Blackstone did some big deals at the peak of the market, but quickly shed the bulk of the riskiest to other investors. Mr Schwarzman is doing his bit to help, offering advice to Gordon Brown on how to rescue the financial system and, on November 4th, proposing a plan of action in the *Wall Street Journal*. All of which may make Mr Schwarzman wonder why he gets so much criticism. Even his $100m gift to the New York Public Library prompted scepticism, not plaudits. The answer is a sobering one for the financial risk-takers on Wall Street. For two decades investors and commentators lent financiers one of their most precious assets: the benefit of the doubt. That asset has now been redeemed.

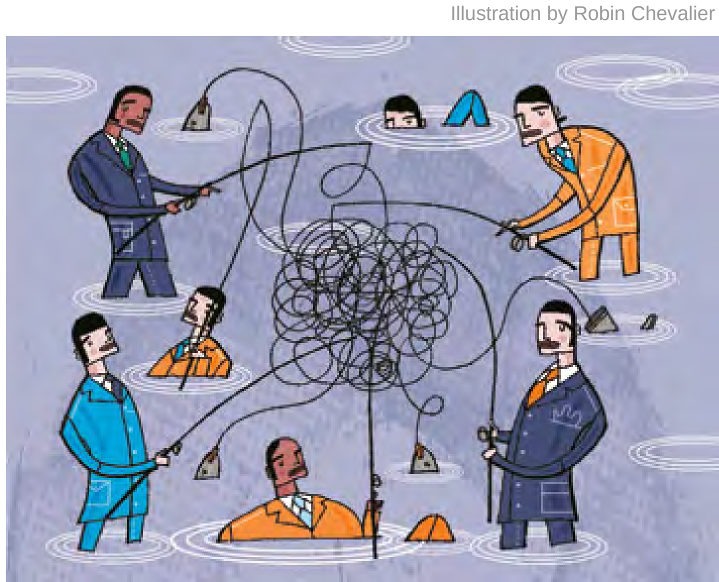
Credit derivatives

The great untangling

Nov 6th 2008 | NEW YORK
From The Economist print edition

Some of the criticism heaped on credit-default swaps is misguided. The market needs sorting out nonetheless

Illustration by Robin Chevalier



THEY are, says a former securities regulator, a "Ponzi scheme" that no self-respecting firm should touch. Eric Dinallo, the insurance superintendent of New York state, calls them a "catastrophic enabler" of the dark forces that have swept through financial markets. Alan Greenspan, who used to be a cheerleader, has disowned them in "shocked disbelief". They have even been ridiculed on "Saturday Night Live", an American television show.

Until last year credit-default swaps (CDSs) were hailed as a wonder of modern finance. These derivatives allow sellers to take on new credit exposure and buyers to insure against companies or governments failing to honour their debts. The notional value of outstanding CDSs exploded from almost nil a decade ago to $62 trillion at the end of 2007—though it slipped to $55 trillion in the first half of this year and has since continued to fall. Traded privately, or "over the counter", by banks, they seemed to prove that large, newfangled markets could function perfectly well with minimal regulation.

That view now looks quaint. Since September a wave of large defaults and near-misses, involving tottering banks, brokers, insurers and America's giant mortgage agencies, Fannie Mae and Freddie Mac, has sent the CDS market reeling. Concern that CDSs are partly to blame for wild swings in financial shares has frayed nerves further.

The failure in mid-September of Lehman Brothers showed that the main systemic risk posed by CDSs came not from widespread losses on underlying debts but from the demise of a big dealer. The aftershock spread well beyond derivatives. Almost as traumatic was the rescue of American International Group (AIG), a huge insurer that had sold credit protection on some $440 billion of elaborate structures packed with mortgages and corporate debt, known as collateralised-debt obligations (CDOs). Had AIG been allowed to go bust, the swaps market might well have unravelled. Similar fears had led to the forced sale of Bear Stearns in March.

Foul-ups with derivatives are hardly uncommon, but CDSs have been causing particular consternation. One reason is the broad threat of "counterparty risk"—the possibility that a seller or buyer cannot meet its obligations. Another is the rickety state of back-office plumbing, which was neglected as the market boomed. A third is that swaps can be used to hide credit risk from markets, since positions do not have to be accounted for on balance-sheets. They make it beguilingly easy to concentrate risk. AIG could have

taken the same gamble in other ways, for instance by borrowing heavily to buy mortgages. But the CDS route was quicker and less visible.

If counterparties pay up, CDSs are a zero-sum game: what the seller loses, the buyer gains. Counterparty risk upsets the symmetry. It is tempting to write lots of swaps in good times, when pay-outs seem improbable, without putting aside enough cash to cover the potential losses. Being AAA-rated, AIG was able to post modest margin requirements—the deposit it had to pay against the risk of the contract being triggered. When its credit rating was cut, a lot more margin was suddenly demanded and it had to turn to the public purse.

“We sent out a signal that the stronger you were, the crazier you could be,” says Mr Dinallo: highly rated companies were allowed to write reckless volumes of swaps. Originally conceived as a means for banks to reduce their credit exposure to large corporate clients, CDSs quickly became instruments of speculation for pension funds, insurers, companies and (especially) hedge funds. And with no fixed supply of raw material, unlike stocks or bonds, bets could be almost limitless.

The industry is scrambling to limit the damage. Robert Pickel, head of the International Swaps and Derivatives Association (ISDA), says he is determined to combat “misconceptions” about CDSs. The true amount at risk, after cancelling out offsetting exposures, is only about 3% of their notional value (that is $1.6 trillion, even so). Opaque as CDSs may be, they are less complex than CDOs. In essence, they unbundle the interest on a debt from the risk that it is not paid back. Selling credit protection is similar to writing certain kinds of common options on shares.

The root cause of the crisis, Mr Pickel argues, is bad mortgage lending, not derivatives: swaps on subprime mortgages grew unstable because the loans themselves were dodgy. Last month JPMorgan’s Blythe Masters, one of the market’s founders, urged regulators to distinguish between tools and their users: “Tools that transfer risk can also increase systemic risk if major counterparties fail to manage their exposures properly.”

That will not reassure everyone. Still, there has been “more fear than facts” around the CDS market, says Brian Yelvington of CreditSights, a research firm. Essentially, it provides fixed-income investors with “a liquid way to do what equity and futures participants have been doing for years: to take a negative as well as constructive view on credit.”

Furthermore, the market has held up better than many expected. The process for settling claims after Lehman’s default and the government’s seizure of Fannie Mae and Freddie Mac “performed as designed”, says Darrell Duffie of Stanford University. Only $6 billion had to change hands in the Lehman auction, overseen by ISDA, because most payments had already been made as swap-sellers marked their positions to market; in all, $21 billion had been theoretically at risk. Margin payments are widely thought to cover two-thirds of total CDS exposure.

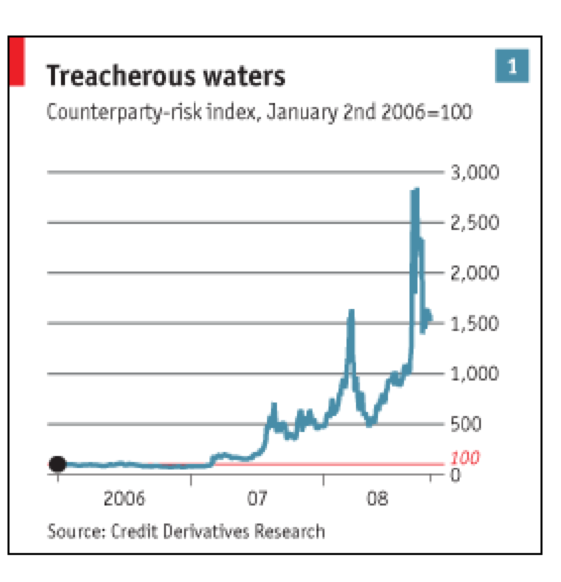
The CDS market has remained fairly liquid throughout the crisis, even as cash markets dried up. At the moment, derivatives spreads reflect fundamental values more accurately than those in corporate-bond markets, reckons Tim Backshall of Credit Derivatives Research (CDR). Swap spreads have become a key barometer of financial health. They provided an early indicator of trouble at investment banks, although they became distorted as more and more firms scrambled to hedge or speculate.

But if credit swaps were not a primary cause of the past year’s conflagrations, they were, in certain respects, an accelerant. Financial eggheads used them as building blocks in “synthetic” CDO-type structures, which are based on CDSs rather than actual bonds. The market value of some tranches has slumped to less than ten cents on the dollar. And CDSs share some problems with securitisation. A paper last year by economists at the Federal Reserve Bank of New York concluded that they “give banks an opaque means to sever links to their borrowers, thus reducing lender incentives to screen and monitor.”

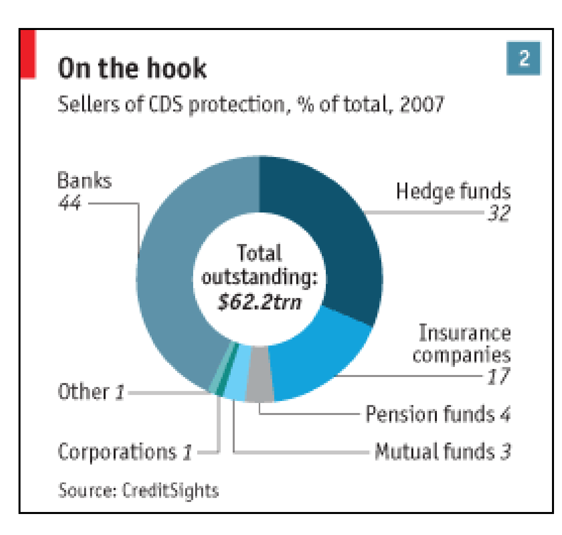
Some fear that worse may be yet to come. The failure of another big actor in the market would send dealers and other counterparties scurrying to replace trades, almost certainly at a higher cost. Replacing those struck with Lehman, as spreads widened after its bankruptcy filing, is thought to have cost some dealers upwards of $200m each.

That risk remains, judging by CDR’s counterparty-risk index, which measures the health of CDS dealers (see chart 1). The next shock could be the failure of a hedge fund with a big swap

book, given the spike in redemptions and margin calls many funds face, thinks Pierre Pourquery of the Boston Consulting Group. Hedge funds wrote almost a third of all credit protection last year (see chart 2).



Sellers of protection will be watching nervously for a wave of corporate defaults as big economies slip into recession. Standard & Poor's expects the default rate on junk-grade debt to leap to 23% by 2010. Sovereign debt is looking wobbly too, especially but not exclusively in emerging markets. The cost of insuring against a default by the United States has quadrupled since January.



As rising defaults trigger CDS payments, the effect on other markets is likely to grow. Credit insurers are increasingly having to find money to pay claims that once seemed merely notional. Christopher Whalen of Institutional Risk Analytics, a consultancy, calls these commitments a "liquidity black hole". Because banks lack the liquidity to cover these positions, they must raise it in interbank markets. This may be keeping the rate at which big banks borrow from each other higher than it would otherwise be, thinks Mr Whalen (though it has fallen from its peak last month). It may also be causing rushed sales in equity and bond markets.

Concern about the damage that the failure of a big swap-seller might yet do has created pressure for the CDS market to be regulated. New York has charitably offered to oversee "covered" swaps—those where the protection buyer holds the underlying bonds; Mr Dinallo labels uncovered CDS trades as "naked", likening them to abusive short-selling of shares. Federal regulators, who passed up several opportunities to police the market during the credit boom, are circling too.

Dealers are hoping to head them off with a series of initiatives, which have been stepped up recently at the prompting of the Federal Reserve. Chief among them is the creation of a central clearing house for credit derivatives. Several groups, including a dealer-backed venture led by Intercontinental Exchange and a tie-up between CME Group, another exchange operator, and Citadel, a hedge fund, are vying for licences. One or more is likely to be awarded in the next few weeks.

The biggest benefit would be less counterparty risk, since each member firm would face only the clearing house, not lots of partners. Standardised collateral arrangements would reduce the sort of payment disputes that have flared up this year, including those between AIG and buyers of its insurance. This set-up has worked well for trading of energy swaps.

Although it would ease one problem, it may create another by concentrating risk in the clearer—"like the military putting all its artillery shells in a single dump," says a banker. Any clearer will need to have "tremendous creditworthiness" and iron-clad risk controls, says Craig Donohue, chief executive of CME, which is planning to back its venture with its $7 billion guarantee fund and $115 billion in collateral.

Besides a clearing house, the market could do with more transparency. A lack of disclosure on CDS exposures has frequently led the market to overestimate risks: had it been realised that settlement payments on Lehman swaps would be only $6 billion, rather than the hundreds of billions feared, much of the turmoil in debt markets could have been avoided. To provide more clarity, the Depository Trust & Clearing Corporation, which runs the central registry for swaps, has just begun publishing weekly data on the largest (but not broken down by counterparty).

A streamlining of back offices, which were swamped as trading surged, is also necessary. Only now is the

industry discovering the joys of “compression”, which allows offsetting swaps to be torn up. A staggering $25 trillion-worth, almost half of the total, has been binned in recent months. Though this does little to cut the amount at risk, it reduces operational costs and strips away a layer of complexity that has obscured trading exposures. There are plans to extend this tidying-up exercise to other derivatives, including interest-rate swaps, whose gross value, $393 trillion at the end of 2007, dwarfs that of CDSs.

All this will strengthen market infrastructure. But it will also eat into the profits of big dealers, such as Goldman Sachs and JPMorgan, at a time when every dollar is precious. Estimates of their total revenue related to CDSs run as high as $30 billion a year. This will fall as central clearing brings more price transparency, and drop even further if the swaps end up being traded on exchanges. The dealers have long argued that bespoke swaps do not belong on bourses. But contracts, especially those tied to indices rather than single names, are steadily becoming more standardised. Most CDSs, thinks a bank regulator, will move to exchanges “within a few years”.

These quasi-voluntary efforts may or may not reassure those calling for more dramatic intervention. Buyers and sellers of swaps will probably be required to disclose more information. They will certainly have to stump up more capital to trade, making the market less attractive. Indeed, since September the typical margin demanded by dealers has more than doubled. Once reshaped, the CDS market will be a bit duller and a lot less lucrative. But it will also be much safer.

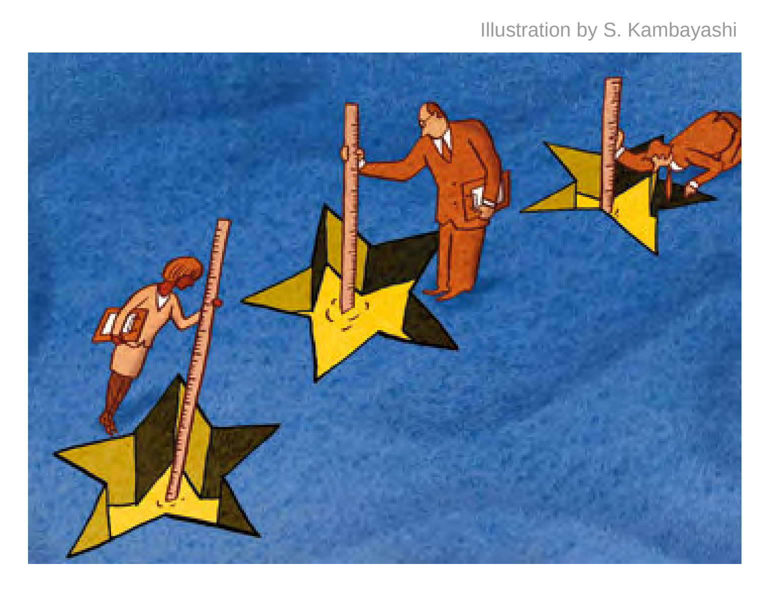
The euro area

All fall down

Nov 6th 2008
From The Economist print edition

A broad-based contraction is well under way in Europe

Illustration by S. Kambayashi



JUST a few weeks ago the main question about the euro-area economy was whether it would avoid recession. Now it is how deep will the downturn be. The region was already struggling before the financial crisis intensified in mid-September. GDP seemed set for a small drop in the third quarter, after shrinking at an annualised rate of 0.7% in the three months to June. A reading of the runes suggests there is worse to come. Alarmed by the speed of the economy's decline, the European Central Bank (ECB) cut its benchmark interest rate on November 6th by half a percentage point, to 3.25%, the second reduction in the space of a month.

Such action is more than justified by recent economic data. In October the purchasing managers' index, a closely watched gauge of activity in manufacturing and service industries, dived from 46.9 to 43.6, a nadir for the ten-year-old survey. A score below 50 indicates the economy is shrinking: October's reading points to a big contraction. Other indicators are scarcely cheerier. The European Commission's measure of economic sentiment slumped to a 15-year low in October (see chart). The Commission slashed its GDP-growth forecast from 1.5% to 0.1% for 2009. Even firms in Germany, the region's hardiest economy, are fearful: a gauge of business expectations compiled by Ifo, a Munich-based research institute, fell in October to its lowest-ever level.

The latest leg of the downturn appears to be broad-based, as the credit drought cramps consumer spending, business investment and exports. Consumers were in retreat long before the recent assaults on their fragile confidence. Household spending shrank in each of the year's first two quarters. It shows few signs of reviving. Retail sales fell by 1.6% in the year to September, and economists at Barclays Capital reckon new-car sales fell to their lowest level in October since 1997, once seasonal factors are adjusted for.

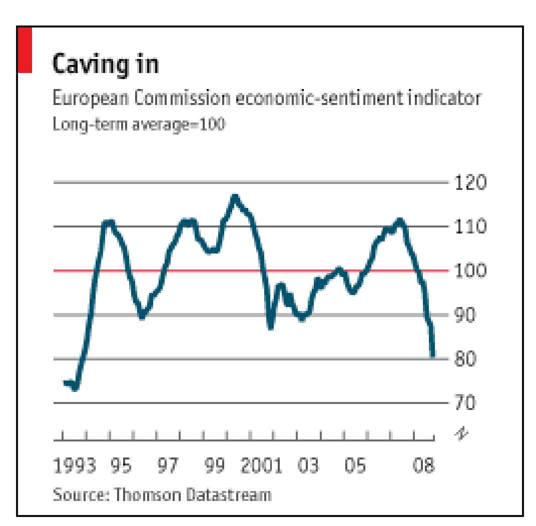
Exports had also already been hurt by the downturn in Britain and America, the euro-zone's two largest overseas markets. As the credit freeze spreads beyond the rich world, sales to fast-growing emerging markets are threatened too. Europe's big capital-goods firms, suppliers of the equipment used to make goods or to build roads, railways, water systems and power plants, have enjoyed four rich years of revenue growth, says James Stettler at Dresdner Kleinwort. Commodity-producing countries flush with cash have been keen buyers. Infrastructure booms in China and eastern Europe have also helped to fatten up order books.

There are some signs that this source of demand has cooled. The share price of ABB, a Swiss-Swedish

infrastructure firm, fell by a fifth on October 23rd after it reported that new orders from the Middle East, and from within Europe, had slowed in the three months to September. It is difficult for buyers to pull out of ambitious capital projects, and there is still plenty of high-priced work in the pipeline. According to Mr Stettler, Alstom, a French engineering group, has an order backlog worth €47 billion ($61 billion), equivalent to more than two years of revenue. A more alarming omen is the 8% fall in German factory orders in September, led by weak foreign demand.

Another likely casualty is capital spending at home by consumer-goods firms, which may now think they have too much capacity. Three luxury carmakers, BMW, Porsche and Daimler, have all said that weak sales mean they will try to trim output by extending their usual Christmas shutdown. Another sign that firms are cutting back came from SAP, a German software giant. The firm's joint chief executive, Henning Kagermann, said recently he had "never witnessed such a sharp decline in customer spending in such a short time."

Is the credit crunch forcing firms to retrench directly? One fear is that as banks scale back their balance-sheets, firms that rely on bank loans will have to act in step, axing their spending to reduce debts. That process would be especially painful for European firms, which rely more on bank finance than American companies do.



Yet the recent fall in business confidence may have more to do with anxiety about customer spending than worries that banks will cut credit lines. Bank loans to non-financial firms rose by 12.1% in the year to September, more slowly than a few months ago but still a fair clip. That said, banks are being more selective about loans. Some industries are likely to suffer more than others. Lenders may look to strengthen ties with their more stolid customers (manufacturers, utility companies and so on) at the expense of retailers, property developers and private-equity firms.

One crumb of comfort for euro-zone firms is that the currency has plunged against the dollar. The long preceding period of euro strength may have left European firms stronger, by forcing them to be more efficient. Its fall should now give exporters a better shot against American rivals in emerging economies. European firms have also been quicker to gain a foothold in these markets. The euro-area's exports to oil-producing countries, for instance, are more than three times bigger than America's, according to the ECB.

The downside of being so cosmopolitan is that European jobs may migrate to low-cost countries. That makes workers at home more anxious (and more loth to spend). Employees are probably right to be wary. The message from recent business surveys is that jobs, as well as capital spending, are in the firing-line.

Thomas Mayer, an economist at Deutsche Bank, believes that the impact of all this will be marked. He reckons GDP in the euro area will shrink by 1.4% next year. Fiscal stimulus will be slow in coming. Germany is best-placed to use fiscal policy to boost demand, because its government bonds are prized by investors fleeing risky assets. But the modest package unveiled on November 5th is too small to provide much of a lift.

Interest rates have also been cut too late to stop the slide. At least inflation is now far less of a worry for policymakers: it has already dropped from a peak of 4% in July to 3.2% in October and is set to fall further. The ECB, having long resisted calls to ease policy, still has some catching up to do.

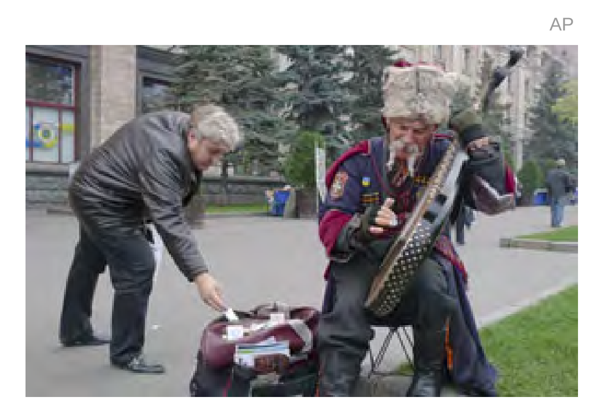
Eastern Europe

Smouldering

Nov 6th 2008 | RIGA
From The Economist print edition

The ex-communist economies have been steadied. Deeper worries remain

AP



How much will you give me to stop playing?

FLAMES out, but smoke still rising. That is how eastern Europe looks after huge outside intervention to douse worries in debt and currency markets. An IMF board meeting on November 5th approved a lightly conditioned $16.5 billion bail-out for Ukraine. Austria has offered a €100 billion ($129 billion) package for its banks, which are owed $290 billion by east European borrowers: Erste Bank took up a €2.7 billion equity injection on October 30th. In Hungary, which has also received an IMF bail-out, markets firmed as parliament passed a tough fiscal package, based on an expected 1% fall in GDP. Serbia, which is in talks with the IMF, said it would not need extra cash, though it might draw on its $695 billion deposit at the fund.

In London Latvia’s central-bank governor, Ilmars Rimsevics, sought to quell fears that his country faced a meltdown on Icelandic lines. Flanked by representatives of Swedbank and Nordea, two Nordic banks which own a large chunk of the local banking system, he said Latvia’s currency peg to the euro was not in doubt. Unlike Iceland, Latvia has little external public debt and a thinly traded currency. But questions remain over some locally owned banks and the legacy of reckless fiscal policies (described by one minister as “hitting the gas pedal”). That brought double-digit growth, but did little for competitiveness. The coming months could bring a contraction of up to 5% in Latvia’s GDP.

The intricacies of Latvian economic policy may no longer hold foreigners’ attention. “We were getting a lot of calls about the Baltics and Scandinavian banks a couple of weeks ago. Now attention has shifted to Bulgaria,” says Neil Shearing of Capital Economics, a consultancy. Bulgaria has a large current-account deficit (expected to be 24% of GDP this year). So far, this has been filled by inflows of foreign direct investment. That looks good on paper (it is reliance on short-term borrowing that sets red lights flashing). But up to a third of that money went into property, inflating a bubble that has now popped.

Neighbouring Romania, the poorest country in the European Union, has problems too. Standard and Poor’s, a rating agency, downgraded its debt to junk last month. And the slowdown in “old Europe” will hit remittances from the many Romanians working abroad.

Foreign investment flows to eastern Europe may be shrinking too, now that businesses in the rich half of Europe have less cash to spare for foreign expansion. Having neglected competitiveness-stoking reforms in education, infrastructure, and public administration, ex-communist countries may find it harder to attract companies needing to cut costs. Governments in eastern Europe are now hurrying to adopt the macroeconomic policies necessary to speed the adoption of the euro. But their countries’ deeper problems remain.

Barclays and Deutsche Bank

Cry freedom

Nov 6th 2008
From The Economist print edition

Rejecting government cash may not be the sign of strength it appears

IT MAY not have been the outcome that Peer Steinbrück, Germany's finance minister, was expecting. But after his outbursts in October—when he said that the managers of banks in the government's bail-out plan to recapitalise them "shouldn't be making more than €500,000 euros ($679,000) a year, no bonuses, no severance pay during this time, and no dividends"—it was unsurprising.

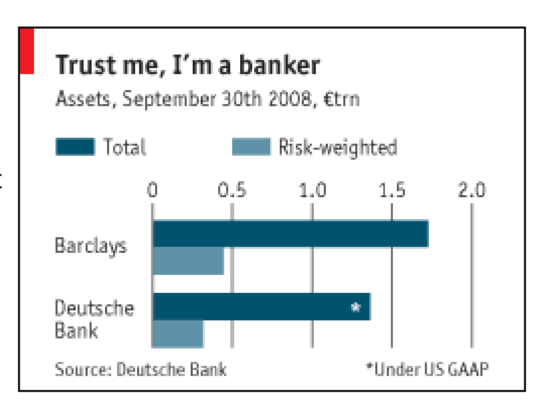
On October 30th Stefan Krause, the chief financial officer of Deutsche Bank, which has spurned the government's rescue plan, told analysts that the bank was "really stepping up efforts to attack our balance-sheet size". Instead of taking money from the government (or private shareholders) to pad the cushion it holds against assets going bad, Germany's biggest bank will concentrate on shrinking. There are ways of slimming without cutting down credit to small businesses and households but that is still arguably the opposite of what governments hope to achieve.

A day later Barclays, Britain's second-biggest bank, told the country's government not to put its cheque in the post either. Instead of joining a programme in which the government is injecting £37 billion ($60 billion) into other big British banks, Barclays raised capital without state help. It said that it had struck a deal to raise £7.3 billion from a group of investors that includes a Qatari sovereign-wealth fund and Abu Dhabi's royal family.

Barclays is paying a high price for raising money on its own. Analysts at Merrill Lynch reckon its shareholders could be paying as much as £3.2 billion more than if it had taken money from the government. (Barclays disputes this figure, but concedes it is paying a premium). The bank's bosses argue that the cost of coming under the thumb of the British government would have been higher still.

The decisions by Barclays and Deutsche Bank to spurn government help may, at first glance, seem like signs of strength. Both have emerged from the first year of the credit crunch with smaller losses on toxic assets than might have been expected, given their involvement in markets that have felled others. Yet a closer look raises more worrying questions.

Although both appear well capitalised when looking at their risk-weighted assets, many investors have been keeping an eye on the amounts of their total assets, which are far larger (see chart). The size of Deutsche's balance-sheet helps to explain why it has the highest net amount of credit-default swaps, a type of insurance against default, written on its debt of any corporate borrower. That also suggests plenty of people think the bank is still at risk of getting into trouble. Both Deutsche and Barclays argue that looking at overall leverage is a poor measure of risk, in part because many of the derivatives they own cancel each other out. For the moment regulators in Germany and Britain are still focusing on risk-weighted capital ratios. But the days of high leverage for both banks are probably numbered.



The two banks' accounting practices are also helping them muscle through the crisis on their own. Barclays has long valued some of the most toxic assets on its balance-sheet at the price it paid for them, rather than their current market value, because it is not trading them, but will hold them to maturity. Most rivals, in contrast, have reported their assets at the market price. As a result they have taken losses—and hits to their capital—as markets have dried up. Short of peering at each loan and derivative, no one really knows what skeletons (if any) are lurking in Barclays' vaults. It is fair to say, however, that its capital ratio would look worse had it accounted for assets differently.

Changes to international accounting rules in mid-October now mean that many more banks can reclassify

assets so they are not subject to mark-to-market accounting. Never one to miss a trick, Deutsche Bank last month said that it too had started to use the less stringent rules, which allowed it to avoid write-downs of about €845m in the third quarter. Royal Bank of Scotland and Lloyds TSB, two other British banks, have followed suit.

Fans of the new rules argue that mark-to-market accounting forced banks into a vicious spiral of forced sales and more losses. But avoiding write-downs will do little to restore trust to a financial system that is sorely lacking it. One bank that decided not to use the extra wiggle-room was France's Société Générale, which announced an 84% drop in third-quarter profits on November 3rd. “This profit isn't artificially enhanced,” Frederic Oudea, its chief executive, said pointedly. If only other bank bosses could say the same.

Oil

Well prepared

Nov 6th 2008
From The Economist print edition

Oil prices have plunged. Another spike may be on its way

AP



WITH the price of crude mired at half the peak of $147 it reached in July, this may seem like an odd time to invest in oil wells. Despite trimming its output along with other members of the Organisation of the Petroleum Exporting Countries (OPEC) in an effort to prop up prices, that is just what the United Arab Emirates plans to do. Short-term price movements, its oil minister insists, should not distract from the world's enduring thirst for oil. Indeed the collapse of oil prices, one of the few reasons around for economic cheer, may be setting the stage for another spike.

Just now oilmen are focused on the rapidly slowing demand for their product. Since early October, reckons the boss of BP, a big oil firm, America's consumption of crude has fallen by perhaps 2m barrels a day, or about a tenth. Sales of cars in America fell even more steeply last month—by 32%. There is also gloomy news from emerging markets, which have been the driving force in the oil markets of late. Demand for oil is growing much more slowly in China and India, for example, and car sales are down in both countries. There is even talk of global oil demand falling next year, for the first time since 1991.

In the face of these grim statistics, OPEC decided last month to pump 1.5m fewer barrels a day (about 2% of global consumption), starting from November 1st. Several of its members want another cut soon. The output of big Western oil firms is also declining, thanks to decreasing output from their existing fields and a relative dearth of new opportunities to replace them. Production continues to fall in once-prolific spots such as Russia, Mexico and the North Sea. So far, faltering demand has outweighed feeble supply, keeping the price near $70 a barrel.

That is below the level needed to justify further investment in the expensive projects open to Western oil firms, such as extracting oil from the viscous tar sands of Canada. The boss of Total, another big oil firm, puts the cost of developing new tar-sands operations at $90 a barrel. Naturally enough, several firms have delayed planned expansions and cut investment budgets. Some refiners are following suit.

The cost of production is no more static than the price of oil. Falling prices for important raw materials, such as steel and natural gas, should help to bring down development costs. By the same token, the cost of hiring some kinds of drilling rigs is falling. The strengthening dollar also helps, points out Paul Sankey of Deutsche Bank, since that tends to increase oil firms' dollar-denominated revenue relative to expenses in other currencies.

But according to Francisco Blanch of Merrill Lynch, the rising cost of capital is likely to outweigh all these benefits. Tar-sands schemes, like most oil projects, are very capital-intensive and so very sensitive to changes in financing costs. He believes that higher borrowing charges could push the cost of new tar-sands developments as high as $150 a barrel by 2010. So if demand for oil has started growing again by then, and if tar sands remain the source of marginal production, then the oil price will have to rise back to this summer's levels to stimulate increased supply. “The age of easy oil”, warns the Emirati minister, “is gone forever.”

Buttonwood

Clare and present danger

Nov 6th 2008
From The Economist print edition

Is this the time to make a long-term bet on equities?

Illustration by S. Kambayashi

SHARE prices do not always go up. Prominent on Buttonwood's bookshelves is a signed volume bearing the title "Dow 100,000: Fact or Fiction" published back in the heady days of 1999. The Dow will get there eventually, but probably not in this columnist's lifetime.

There is a flaw in the belief, widely held in the 1990s, that all one has to do is "buy and hold" equities to ensure a handsome return in the long run. Just ask Japanese investors. The Nikkei 225 average recently fell to a level last seen only in 1982 and even after a rally still trades at less than a quarter of its 1989 peak.

That makes the bet of Clare College, one of Cambridge University's oldest seats of learning, all the more interesting. It has borrowed £15m ($24m) for 40 years at a real (after-inflation) yield of 1.09% and plans to invest the proceeds in equities. In effect, it has turned part of its portfolio into a hedge fund, using borrowed money to speculate on the stockmarket. At an inflation rate of 3%, it will have to repay around £75m in 2048. Will future dons be throwing themselves off the famous Clare bridge?

The idea that shares should outperform in the long run stems from a fundamental principle of finance—that greater risk leads to greater reward. Shareholders get paid only after a company's creditors have been satisfied. In the case of a corporate failure, they normally lose everything. In addition, equities are more volatile than government bonds.

Investors need to be compensated to take on those risks in the form of higher long-term returns—the equity-risk premium. Researchers at the London Business School suggest this premium over bond returns has averaged around 4% a year over the past century. The compounding effect on the portfolios of those who bought equities rather than bonds is stupendous.

But the term "risk premium" is there for a reason. As John Ralfe, an investment consultant, has pointed out, it is possible to insure a portfolio against a stockmarket decline via the options market. If markets were certain to go up, that cost should diminish over time. In fact, the cost rises. Mr Ralfe estimates it would cost 35% of the value of the portfolio to buy an option for a 40-year period. He argues the figure implies that Clare is making a very risky bet.

Is this option price a realistic comparison? If companies did not produce a return sufficient to pay shareholders more than 1% a year in real terms over 40 years, the firm that offered insurance against such an event would probably not be around to pay up. Indeed capitalism would almost certainly be in trouble. Such a calamity is possible. There is a survivorship bias in long-term investment numbers, since they focus on successful democracies in America and Europe. Back in 1900, an investor might have believed Russia and China to be good long-term bets, only to see his savings wiped out by revolution.

But if revolution occurs, the dons will have other things to worry about than share prices. Such upheavals tend to damage investors in all asset classes, including bondholders and property owners. This is not a risk one can easily insure against.

Political factors aside, the very belief that equities always rise over the long run may sow the seeds of its own destruction. It can lead to investors blindly buying shares at any price and pushing valuations up to ridiculous levels. This clearly happened in Japan in the 1980s.

There are two key components of long-term equity returns: dividend (or profits) growth and valuation

changes. In the second half of the 20th century, equity returns were given an enormous boost by higher valuations. In the past eight years, they have taken a savage hit, despite the growth in economic output and corporate profits, as valuations have returned to normal.

Stockmarkets may not be at their cheapest ever, but they are discounting an awful lot of bad news. Barclays Capital reckons a 51% fall in European dividends is already reflected in prices. And the evidence suggests that share prices are mildly mean-reverting. Long periods of bad performance are followed by periods of good performance, and vice versa.

Indeed, Clare seems to have played a remarkably shrewd game. It sold American equities in 1999 when valuations were ridiculously high and is making this bet only after global stockmarkets have almost halved this year and at a time when the cost of long-term inflation-linked borrowing is very low. Unlike a bank, it does not have to mark its positions to market. Unlike a fund manager, it does not have to worry about losing clients. One suspects the dons will still be enjoying their sherry in 2048.

India's monetary policy

Traffic duty

Nov 6th 2008 | DELHI
From The Economist print edition

India’s policymakers try to keep the money flowing smoothly

AMERICA’S Treasury still seems a trifle embarrassed about owning big stakes in the country’s largest banks. But in India the government is not bashful at all. It has long held controlling stakes in 28 of India’s 79 commercial banks, and it is not afraid to use the clout that ownership affords.

On November 4th the finance minister called the bosses of state-owned banks in for a chat. Afterwards, they said they would cut their lending rates by 0.75 percentage points, a move that will force their privately owned competitors to follow suit. By twisting their arms, the finance minister completed the job begun three days earlier by the central bank, the Reserve Bank of India (RBI). Its governor, Duvvuri Subbarao, had interrupted his weekend to lower its “repo rate”—the rate at which it lends to banks—from 8% to 7.5%, having cut it from 9% to 8% only 12 days before (see chart).



The rate cut was accompanied by other measures to unclog India’s banking system, which is becoming as congested as its city streets. Mr Subbarao cut the share of deposits a bank must set aside in the central bank’s vaults (the “cash reserve ratio”) and raised the amount a bank could borrow at its door. These measures will release 1.2 trillion rupees ($24 billion) into India’s banking system.

It seems to need them. On October 31st, the day before Mr Subbarao sprang into action, interest rates in India’s money market jumped to over 20% for the second time in as many months. In India’s cities a traffic accident on one street will quickly overburden alternative routes. Something similar appears to have happened in India’s money market after the wheels came off Lehman Brothers, according to a study by Ajay Shah and Ila Patnaik of the National Institute of Public Finance and Policy, and Jahangir Aziz of JPMorgan. The disruption following Lehman’s demise meant that India’s globe-trotting companies could no longer raise funds abroad. They tried instead to raise money at home. But their sudden demand for cash was more than India’s banks could comfortably handle.

India’s banks should escape any accidents of their own. Most are slow but sturdy vehicles, financed by deposits. But they share the road with more nimble and vulnerable competitors: the “non-bank financial companies” or NBFCs. These companies attract customers neglected by the banks, offering credit cards and motorbike loans to consumers and helping small businesses borrow to buy a tractor, lathe or diesel generator. They do not take demand deposits, relying on short-term borrowing instead. Unfortunately, such finance is increasingly difficult to find. As part of his traffic duty, Mr Subbarao made it easier for banks themselves to lend to these NBFCs. This may help them survive. But if India’s non-banks must rely on its banks, there is perhaps little point in their having a separate existence.

For the moment, the central bank’s actions seem to have calmed the money markets, where rates fell below 7% on November 5th. But its efforts to keep the banking system liquid are somewhat stymied by another cause it holds dear: stabilising the rupee. Judging by its foreign-exchange reserves, which dropped by $15.5 billion in the week ending on October 24th, it is selling dollars and buying rupees in order to break the fall of the currency, which was briefly worth less than 2 American cents during trading in late October. But the central bank’s purchases of the Indian currency have the effect of draining rupees from the financial system, even as it is doing everything else it can think of to pump more money in. The RBI’s traffic signals risk becoming a little confused.

Asian credit markets

Undergoing repair

Nov 6th 2008 | HONG KONG
From The Economist print edition

An Indonesian court restores a bit of credibility to corporate-bond issuers

IF SOARING markets allow for all manner of bad things to happen, crashing markets can prompt badly needed improvements. Take the decision by the Indonesian supreme court, let slip to reporters on October 31st, to reverse its support for lower-court rulings that had freed a subsidiary of Asia Pulp & Paper from $500m in debt obligations incurred in the mid-1990s. The court's initial stance, taken in 2006, sent a shudder of fear through Asian debt markets. The reversal offers them a bit of comfort.

Asia Pulp & Paper was among many companies to suffer during the 1997-98 financial crisis and in 2001 it defaulted on $14 billion in debt. It then attempted to void some of its obligations through a series of cases in Indonesia's courts contesting the structure of the bonds. As so often in Asia, the instruments were complex: they were registered in the Netherlands and included a clause for disputes to be arbitrated in New York. To the surprise of many international investors, the right of a subsidiary, PT Indah Kiat Pulp & Paper, not to repay its creditors was upheld.

In the aftermath of that decision, there was some concern that many other bonds might suffer a similar fate. A booming global economy, however, meant that defaults were too rare to test that theory. Investors, desperate for yield, simply ignored the implications of the ruling. Spreads on emerging-market debt in general, and Indonesian debt in particular, did not widen. The one change was that in accordance with disclosure policies in most developed markets, a new “risk” was added to the offering documents of many Indonesian bonds. Along with insurrection, earthquakes and targeted bombing of key areas, investors were told that the legal validity of their holdings was suspect.

As the markets have turned down, that sort of risk has taken on a new importance. In anticipation of rising defaults, every security in the pipeline of an investment bank is being scrutinised for potential dangers. The appetite for any offering is weak—issuance by local borrowers is sharply down this year, according to Dealogic, a data provider. It is weaker still for a bond lacking legal protection. So the supreme court's decision to reverse itself may not have been coincidence.

Ordinarily, bondholders and potential bondholders ought to be pleased by such a decision. But it was greeted with grumbling as well. An official copy of the decision has still not reached litigants and critical details remain unknown, among them when the ruling actually occurred. One investment firm, Oaktree Capital, settled its claims in September and may have done so unaware that the law was already in its favour. Things are getting better, but it would be hard to conclude they are good.



Economics focus

The global slumpometer

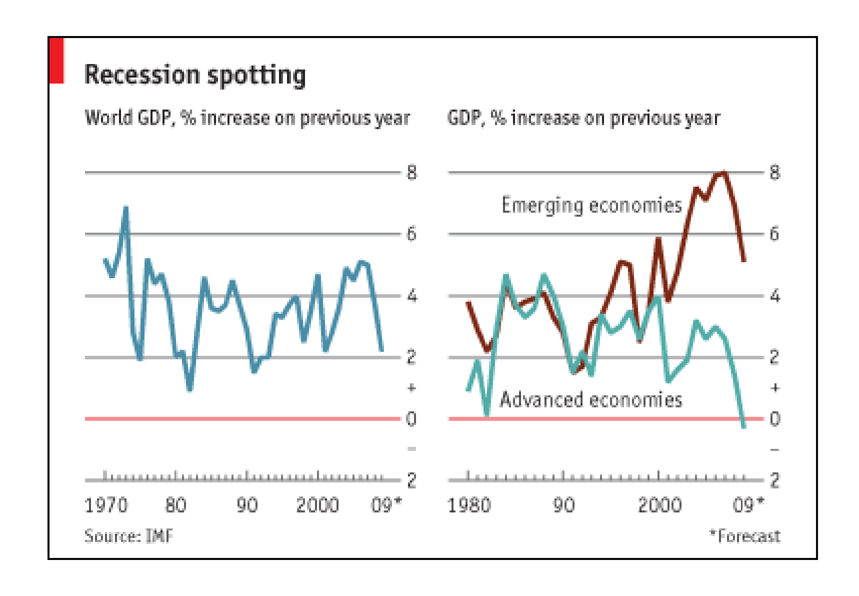
Nov 6th 2008
From The Economist print edition

Rich countries face their deepest recession since the 1930s. For poorer nations it could still be relatively mild

MANY economists are now predicting the worst global recession since the 1930s. Such grim warnings discourage spending by households and businesses, depressing output even more. It is unfortunate, therefore, that there is so much confusion about what pundits mean when they talk about a "global recession".

America, Britain, the euro area and Japan are almost certainly already in recession according to the popular rule of thumb of two successive quarters of falling GDP. But is the R-word really justified for the world as a whole? In an updated *World Economic Outlook*, published on November 6th, the IMF predicted that world GDP growth would fall to 2.2% in 2009, based on purchasing-power parity (PPP) weights, from 5% in 2007 and 3.7% in 2008. In the past, the IMF has said that global growth of less than 3% implied a world recession, so its latest forecasts would push the world over the edge. Some forecasts by private-sector firms are even gloomier, with several now predicting global GDP growth of no more than 1.5% in 2009.

But why does the IMF think that a world economy growing by less than 3% a year is in recession? To many people, growth of 2.9%, say, sounds pretty robust. Surely a drop in output is required? The trouble is that there is no agreed definition of a global recession. The popular benchmark used in developed economies—two successive quarters of decline—is not helpful when looking at the world as a whole, because many emerging economies do not report seasonally adjusted quarterly GDP figures. Also, downturns are rarely perfectly synchronised across countries, so even if most countries contract at some stage during a two-year period, global GDP growth may not turn negative. Indeed, global GDP has never fallen in any year since the 1930s Depression. Its worst years since then were 1982 and 1991, with growth of 0.9% and 1.5% respectively (see left-hand chart).



World growth also needs to be adjusted for rising world population. The IMF suggests that a sufficient (although not necessary) condition for a global recession is any year in which world GDP per head declines. In each of the downturns in 1975, 1982 and 1991, growth in world GDP per head turned negative. By contrast, in 2001, despite much talk of "the mother of all recessions", global GDP per head expanded by around 1%. The annual growth rate in world population has now slowed to 1.2%, so recent GDP forecasts would still allow average world income per head to rise.

If market exchange rates are used to measure world output instead of PPPs, then some recent forecasts

would imply a fall in world GDP per head. However, the IMF believes that PPP weights are more appropriate, because a dollar buys a lot more in poor countries than in America, thanks to lower prices. Converting China's GDP into dollars at market exchange rates therefore understates the true size of its faster-growing economy and, in turn, understates world growth.

The IMF's definition of global recession also takes account of the fact that the trend growth rate in emerging economies is higher than in developed ones, so even a steep downturn will leave GDP still expanding. A growth rate of 4% would count as a boom in America, but a recession in China. Nevertheless, some economists reckon that the IMF's 3% benchmark for global recession may be too high. UBS, for instance, suggests a demarcation point of 2.5%. Even the IMF now seems less sure. At the original launch of the *World Economic Outlook* in October, Olivier Blanchard, the fund's chief economist, said "it is not useful to use the word 'recession' when the world is growing at 3%".

When tracking such diverse economies, it does make much more sense to define a global recession not as an absolute fall in GDP, but as when growth falls significantly below its potential rate. This can cause anomalies, however. Using the IMF's definition (ie, growth below 3%), the world economy has been in recession for no fewer than 11 out of the past 28 years. This sits oddly with the fact that America, the world's biggest economy, has been in recession for only 38 months during that time, according to the National Bureau of Economic Research (the country's official arbiter of recessions), which defines a recession as a decline in economic activity. It is confusing to have different definitions of recession in rich and poor economies.

Growing apart

Before proclaiming global recession, it is also important to consider the extent to which a downturn has spread around the world. As stockmarkets and currencies have slumped in emerging economies and some governments have had to knock on the IMF's door, it might appear as if these economies are being hit harder than rich countries. Even in China, growth seems to be slowing sharply, prompting the government to lift its quotas on bank lending at the start of this month. Yet most emerging economies are still widely expected to hold up much better than in previous global downturns.

It is only really the developed world that faces severe recession (see right-hand chart). The IMF's revised November figures now forecast that the advanced economies will shrink by 0.3% in 2009, which would be the first annual contraction since the war. The IMF has become markedly more bearish on emerging economies since October, revising its forecasts downward by an average of a percentage point. But emerging economies are still tipped to grow by around 5%. This is a sharp slowdown from recent growth of 7-8%, but still above their average growth rate over the past three decades and considerably higher than their typical growth in previous global downturns.

These numbers could of course, be revised down still further. But if broadly correct, this could be a relatively mild downturn for emerging economies. Real income per head is still expected to increase next year in countries that account for well over half of the world's population. Indeed, if the developed world as a whole suffers an absolute decline in 2009, next year is set to be the first year on record when emerging economies account for more than 100% of world growth.

Award: Philip Coggan

Nov 6th 2008
From The Economist print edition

Philip Coggan, our Buttonwood columnist and capital-markets editor, was named "Journalist of the year—investment issues (national)" at the 2008 State Street Institutional Press Awards in Britain.

Treating tumours

Golden slingshot

Nov 6th 2008
From The Economist print edition

Illustration by Stephen Jeffrey



The next generation of cancer treatments may be delivered by nanoparticles

JOURNALISTS sometimes joke that the ideal headline for a science story would be something like “Black holes cure cancer”. Sadly, it will never happen. “Nanotechnology cures cancer”, though, is a pretty good runner-up, and that might just turn out to be true.

In fact, nanoparticles (ie, objects whose dimensions are measured in nanometres, or billionths of a metre) have been used to treat cancer for some time. But these treatments are mainly clever ways of packaging existing drugs, rather than truly novel therapies. For instance, Doxil, a medicine used to treat ovarian cancer, is wrapped up in naturally occurring fatty bubbles called liposomes. Taxol, a common breast-cancer drug, is similarly packaged with naturally occurring blood proteins in a product called Abraxane. In both, the packaging aids the delivery of the drug and reduces its toxic side-effects.

Now, however, a second generation of nanoparticles has entered clinical trials. Some are so good at hiding their contents away until they are needed that the treatments do not merely reduce side-effects; they actually allow what would otherwise be lethal poisons to be supplied to the tumour and the tumour only. Others do not depend on drugs at all. Instead, they act as beacons for the delivery of doses of energy that destroy cancer cells physically, rather than chemically.

One example of this second approach comes from Jennifer West’s laboratory at Rice University in Houston, Texas. Building on work by her colleague Naomi Halas, Dr West has constructed gold “nanoshells” that either absorb light or scatter it, depending on their design. The shells are built on a core of silica whose shape can be adjusted to produce the desired effect. Dr West then paints a layer of gold, 15 to 20 nanometres thick, over the silica core.

Shell shock

The first nanoshells made by Dr West are designed to absorb infra-red light. When they do so, they heat up. And when they heat up, so the theory goes, they will cauterise any nearby cancer cells.

To get them to the cancer, you whip up a batch of, say, 80 trillion of them and inject it into the patient’s bloodstream. The particles end up in the tumour, rather than in healthy tissue, because tumours have abnormal blood capillaries. The pores in these vessels are larger than those in healthy tissues. Make your nanoshells the right size, then, and they can pass through the capillary pores and lodge in a tumour, but not in a normal organ. Twelve to 36 hours later, when enough shells have accumulated, you insert an

optical fibre into the tumour, and deliver an appropriate blast of infra-red. That heats the particles up and cooks the tumour.

This procedure, known as photothermal ablation, has undergone six years of animal testing. The results are encouraging. In mice, tumours disappeared in 10-14 days and the animals remained cancer-free thereafter. Dogs, too, gave "excellent data" according to Donald Payne, the boss of Nanospectra Biosciences, Dr West's commercial partner, although he is cagey about the details, pending publication. Nanospectra is, however, now conducting trials at three medical centres in Texas on people with head and neck cancers.

One advantage of photothermal ablation is the lack of a chemical agent. That means no toxicity. Of course, safety questions about the particles themselves remain, but Dr West and Dr Payne both say they have seen no signs of harmful symptoms. Surplus particles are cleared away by the liver, spleen and lymphatic system, or are mistaken for bacteria and eaten by macrophages, one of the types of white cell in the bloodstream. Though they may remain in those macrophages for a long time, Dr West says that this longevity does not seem to cause problems.

Nor is photothermal ablation the only way of heat-treating cancer cells. MagForce Nanotechnologies, based in Berlin, has conducted three clinical trials of anti-cancer nanoparticles made from iron oxide and is now running another five. These particles are injected directly into the target tumour, rather than relying on the leaky walls of tumour capillaries to get them to the right place. Once there, they can be heated using alternating magnetic fields that are easily tolerated by patients. According to Andreas Jordan, the firm's chief scientist, this procedure has no side-effects and shows particular promise against glioblastomas, a deadly type of brain cancer, and against prostate cancer.

Other researchers on nanoparticles, though, prefer to put their faith in drugs. CytImmune Sciences of Rockville, Maryland, has just begun a study of the efficacy of Aurimune, a solid-gold nanoparticle that carries a dose of tumour necrosis factor (TNF), a substance that has a natural tendency to stick to gold.

It is also a substance hitherto regarded as too toxic for people to tolerate. It gets its name because it attacks the blood capillaries that feed a tumour. It cannot, however, distinguish between the capillaries in a tumour and those elsewhere. With natural TNF that does not matter, since the substance is produced only in the tumour itself. But if you inject TNF directly into a patient's bloodstream he will suffer massive organ failure brought on by a precipitous fall in his blood pressure.

What's your poison?

The trick, then, is to concentrate the TNF in the tumour. That can be done surgically, by a procedure known as isolated limb perfusion. But this is complicated, and the treatment works only in about three-quarters of cases. CytImmune hopes that its method will be simpler. It intends to use Aurimune as a way of delivering TNF to the tumour site, and only to the tumour site, by employing the "leaky wall" effect to get the particles to the right place.

According to Lawrence Tamarkin, CytImmune's boss, when Aurimune was run through safety trials it was able to deliver doses of TNF that were as high or higher than those which isolated limb perfusion could manage, and without serious side-effects. The only side-effect that has been noted so far is a transient fever that can be treated with over-the-counter medicines.

Calando Pharmaceuticals, of Pasadena, California, is also packing nanoparticles with a substance previously too dangerous to use. In this case the drug is called camptothecin, and the nanoparticle is made from a strand of sugar molecules. As the camptothecin is attached to the sugar molecules, the strand folds up into a sphere, hiding the drug inside as a clenched fist might hide a pea.

The result, called Cyclosert by the firm, is being tested to see if it can prevent the progression of ovarian cancer. Some 150 patients who have completed standard chemotherapy for this disease, which would normally then be followed by a period of what is known as "watchful waiting", will, instead, be given Cyclosert. Since ovarian cancer often recurs, that will, by dint of comparison with a control group who undergo watchful waiting alone, allow the researchers to assess whether Cyclosert reduces recurrence.

Like Nanospectra and CytImmune, Calando relies on the leaky walls of tumour capillaries to deliver its products. But nanoparticle therapies of the generation after that may be smarter. Dr West has now started attaching antibodies to her gold nanoshells. Since antibodies have specific affinities to particular

proteins, any nanoshells covered in antibodies to those proteins found almost exclusively on the surfaces of tumour cells will stick to those cells and no others. That way, when the light is applied, only the unhealthy cells should be killed.

Moreover, Dr West is also working on particles that both scatter and absorb light. These would reveal the extent of any tumour if illuminated with a low-power beam. That would tell surgeons where to point a high-powered killing beam so that no cancerous tissue was missed.

It may, of course, all come to nothing. The war on cancer is being pursued on many fronts, and this is just one of them. But the idea looks promising because it is based on a general principle rather than a specific practice. This means that if one particular version fails, others might still succeed. Cynicism aside, that fact alone is worth the headline.

Alternative energy

Is it plane?

Nov 6th 2008
From The Economist print edition

How to make radar work in wind farms

WIND farms are controversial. Some people think they are an excellent way to generate green electricity whereas others reckon they are a blot on the landscape and a danger to birds. Such arguments aside, aviation safety is one of the main reasons why plans to build wind farms are held up. The concern is that they interfere with the radar used in air-traffic control. Some people even argue that they could be used as cover by enemy aircraft in time of war. In Britain such worries have caused the shelving or refusal of more than 40 proposed wind farms. Now, however, an Anglo-American company called Cambridge Consultants thinks it has come up with a snazzy way of solving the problem. It calls its invention holographic-infill radar.

The standard radar used by air-traffic control centres can see a long way, but finds it difficult to tell between a moving aircraft and the whirling blades of a wind turbine. Radar works by sweeping a pulsed radio signal around a wide area and then measuring the time it takes for the signal to be reflected back by any objects in its path. This allows the position of those objects to be plotted on a screen. Aircraft can normally be distinguished from stationary objects because the Doppler effect changes the frequency of the returned signal (a familiar example of this effect is the changing pitch of the siren as a police car approaches, passes and recedes).

Although a wind turbine does not change position, its blades are moving and these also cause a Doppler effect. The returning signal from a wind turbine thus creates illuminated blobs on a radar screen that look just like moving aircraft. Moreover, the blobs do not keep still because every four seconds or so, as the radar beam sweeps past, the signal is bounced back by different parts of the turbine’s blades in unpredictable and confusing ways. The clutter this causes on the screen is made worse when the signal is bounced around between different turbines in the same farm. The result is that wind farms can be impossible to filter out because the resolution of a typical long-range radar is not high enough to detect the difference between the Doppler effect caused by an aircraft and that caused by a wind turbine.

Holographic-infill radar would deal with this by creating a “patch” covering each farm that could be applied to the wider air-traffic control radar image. The patch would be created by bathing the farm in a continuous stream of radar pulses at short range, rather than sweeping a beam over it from a distance. The reflections of these pulses, when fed into a computer, would provide what was, in effect, a moving radar picture of the farm. If an alien object, such as an aircraft, intruded into this picture, it would be easy to spot.

Cambridge Consultants has already tested a small-scale version at the site of a single wind turbine. It was able to show a different Doppler effect for a target moving on the ground from the one produced by the turbine’s blades, according to Craig Webster, who is in charge of clean technologies at the company. The next step is to see if this can be repeated over a wider area and with a flying object; in this case a radio-controlled model helicopter.

Eventually, Cambridge Consultants hopes to build a full-sized demonstration system at a wind farm. If that works, it would mean that potential blind spots in the radar network could be illuminated, clearing the way for more investment in green electricity.

Biodiversity

Forest-friendly farming

Nov 6th 2008
From The Economist print edition

“Betel nuts” show one way to mix crops and conservation

FARMING and wildlife are not easy bedfellows. All around the world, species are vanishing as their habitat is turned over to crops. Such land conversion is particularly severe in the tropics, where most of the world’s species live. And though nature reserves offer some respite, they are unlikely to be enough on their own. What would help would be to encourage forms of farming that are in harmony with the conservation of biodiversity.

Jai Ranganathan, of Stanford University, and his colleagues think they have found one. As they report in the *Proceedings of the National Academy of Sciences*, they conducted a survey in the Western Ghats, a mountain range in south-west India. This region has been cultivated for over 2,000 years but remains a hotspot for biodiversity. They looked at birds in different areas of vegetation, including intact forest, plantations and shrub land.

The bird species of greatest concern, such as the Great Hornbill, are found in or near forests. No surprise there. The surprising finding was that local plantations of areca palms retained 90% of the birds associated with native forest.

The fruit of this palm is sometimes used in medicines but is mostly chewed along with betel leaves as a mild, coffee-like stimulant—resulting in a brilliant red stain on people’s teeth. This practice is widespread in India and its neighbours, in Taiwan, and in parts of South-East Asia and Melanesia.

Because the fruits (widely, but incorrectly, referred to as “betel nuts”) come from tall stands of lush trees, farming them provides habitat for the forest birds in the region. In addition, areca-palm plantations are usually intercropped with species such as vanilla, pepper, bananas and coconuts. All this makes those plantations structurally complex. And structural complexity is something that makes forests hospitable to lots of species. The plantations also rely on mulches made from leaf litter deposited in nearby forests. This form of agriculture therefore depends on having reasonably intact local forests to provide the mulch. That, too, is biodiversity-friendly.

This is not, of course, to argue that the whole of southern Asia’s farmland should be turned over to areca palms. But there may be some wider lessons to be learnt. The multiple crops grown in areca plantations make them profitable operations, so there could be economic as well as environmental benefits to trying to extend the idea to other types of farming. Unfortunately, that would be hard in the case of the area’s main crop, rice. A pity. But you have to start somewhere.

Pest control

United we fall

Nov 6th 2008
From The Economist print edition

Surprisingly, two pests together may do less damage than one by itself

IF AN introduced pest gets going in a new habitat, a common response is to find a predator that likes to eat it and release that, too. But a discovery just published in *Ecology*, by Evan Preisser of the University of Rhode Island and Joseph Elkinton of the University of Massachusetts at Amherst, suggests an alternative approach that might be viable: introduce another pest that will compete with the first one.

Dr Preisser and Dr Elkinton experimented with two Asian sap-sucking insects, the hemlock woolly adelgid and the elongate hemlock scale-insect, that have plagued the hemlock forests of North America over the past century. The researchers infested groups of hemlock trees (which are unrelated to the poisonous herb) with one or other parasite, with both, or with none, and found that the woolly adelgid causes much more damage than the scale-insect. The former restricted the growth of the trees' branches by a third over the course of two and a half years, compared with uninfested trees. The latter, by less than a twentieth. What was curious, though, was that the growth-restriction of trees infested by both species was only twice that of those that had the scale-insect alone—in other words, less than a tenth.

The authors suggest this is the result of competition between the two pest species. Although both feed by draining the hemlocks of their juices, the adelgids also inject toxic chemicals into the trees. The presence of scales kept the adelgid's numbers down, which led to less toxin and healthier hemlocks. The conclusion, therefore, is that although it is best to have no pests at all, there are at least some circumstances when two invasives are better than one.

Prince Bandar bin Sultan

Larger-than-life diplomacy

Nov 6th 2008
From The Economist print edition

Getty Images



Prince Bandar bin Sultan was an envoy like no other

EVEN in a region as turbulent as the Middle East, few men have been as influential, as colourful or as flawed as Prince Bandar bin Sultan. As the Saudi king's personal envoy and then for more than 20 years his nation's ambassador to Washington, DC, the prince dealt with—by David Ottaway's estimation—"five US presidents, ten secretaries of state, 11 national security advisers, 16 sessions of Congress, an obstreperous American media, and hundreds of greedy politicians". No Arab ambassador—perhaps no ambassador—has come close to matching Prince Bandar's influence in the American capital. At the height of his powers he was indispensable to both sides: in Mr Ottaway's words, "at once the king's exclusive messenger and the White House's errand boy".

The King's Messenger: Prince Bandar bin Sultan and America's Tangled Relationship with Saudi Arabia
By David B. Ottaway



Walker & Company; 321 pages; $27

Buy it at
Amazon.com
Amazon.co.uk

An authorised life by William Simpson, "The Prince", which came out in 2006, reflected Bandar's considerable talent for self-promotion. But in his new biographer he has met his match. During Mr Ottaway's 35 years at the *Washington Post*, the reporter observed the Saudi diplomat closely and interviewed him often. When it came to royal leaks, the *Post* was Prince Bandar's paper of choice. No outsider can fully penetrate the Saudi kingdom's opaque world of court intrigue and Islamic zealotry, but Mr Ottaway does a creditable job. The portrait of Bandar that emerges is of a fighter pilot, drawn reluctantly into diplomacy, who became one of the master manipulators of that craft.

Some of his feats are well known. In the Reagan years, he secured the purchase of AWACS surveillance aircraft in the teeth of fierce Israeli and congressional opposition. He secretly supplied cash to fight cold-war causes: $32m to the Nicaraguan contras, Mr Ottaway says, and $10m to bolster anti-communist politicians in Italy. When America turned down one particular arms request, Prince Bandar, undeterred, bought missiles from China, hoodwinking the CIA and infuriating the State Department.

Successive American administrations were both seduced and maddened by him. He was energetic, charming, profane. With his love of baseball, expensive living and fat cigars he was the all-American Arab. But if officials came to depend on him, they also learnt that he could be devious, ruthless and manipulative. Was he working for the House of Saud, America or himself? It was not always easy to know. In one incident, officials in the Carter administration discovered the prince had deliberately

mistranslated an important letter from the then Saudi ruler, King Fahd, to President Sadat of Egypt, to make it sound more conciliatory. (This was at a time when Sadat was being vilified in the Arab world for signing the Camp David peace accords with Israel.) Freelancing seemed to come naturally to the prince.

There were good years and bad. The prince worked best with Republican administrations. In the Reagan years, a golden age for the Saudi-American bond, the two countries were staunch allies against communism. In the first Bush presidency the common enemy was Iraq. Saddam Hussein's invasion of Kuwait was traumatic for Saudi Arabia: King Fahd's decision to invite 500,000 American troops into the kingdom triggered a wave of Islamist dissent. But Prince Bandar worked through it alongside President Bush's senior team: James Baker, Brent Scowcroft, Dick Cheney and General Colin Powell. As Mr Ottaway records, the prince became virtually part of the administration, able to enter the White House unannounced and enjoying the rare privilege of a State Department security detail. Prince Bandar later recalled that he ate more pizza at late-night meetings during the autumn and winter of 1990-91 than in his entire life before or since.

Although Mr Ottaway is reluctant to write the prince's political obituary, this is a story with clear elements of decline and fall. Bandar's star began to fade when Bill Clinton entered the White House in 1993. Even the election eight years later of the younger George Bush, a family friend, failed to remedy matters. Crown Prince Abdullah, the de facto Saudi ruler, who was appalled at the administration's apparent indifference to Palestinian suffering in the second *intifada*, told Bandar to deliver a tough message threatening to freeze relations. He did so with a heavy heart, but within weeks there was worse to come. Secluded in front of his customary bank of televisions, on a rare day off in his Virginia mansion, the prince watched the World Trade Centre being attacked. Much of his life's work (and Saudi-American relations) went up in smoke when it emerged that most of the terrorists who struck the Twin Towers came from Saudi Arabia.

In a long, rambling and self-justificatory late-night interview with Mr Ottaway soon after, Prince Bandar unburdened himself, trying vainly to defend the kingdom against a new army of detractors. He stayed on in Washington, but had clearly had enough. In 2005 he finally left to become national security adviser to Abdullah, who had recently become king. He made plans for a grand leaving party, and then cancelled it.

Mr Ottaway's book is not, strictly speaking, a biography. It says little about Bandar's early years and virtually nothing about his family. Two books due out in the next few weeks, Patrick Tyler's "A World of Trouble" and "Innocent Abroad" by Martin Indyk, will add detail to the wider canvas on which Prince Bandar worked. But as a study of the larger-than-life figure who served as broker of the strange, complex and conflicted marriage between America and Arabia, Mr Ottaway's work is surely definitive.

The King's Messenger: Prince Bandar bin Sultan and America's Tangled Relationship with Saudi Arabia.
By David B. Ottaway.
Walker & Company; 321 pages; $27

Economist.com BOOKS & ARTS

Europe 1900-14

The vertigo years

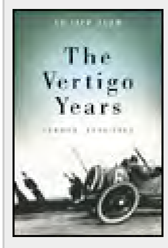
Nov 6th 2008
From The Economist print edition

IMAGINE, suggests Philipp Blom, that a "voracious but highly selective plague of bookworms" had deprived us of all knowledge of 20th-century history after 1914. How would the early years of the last century look when taken on their own, rather than overshadowed by the cataclysm of the first global war?

Illustration by Daniel Pudles



The Vertigo Years: Europe 1900-1914
By Philipp Blom



Basic Books; 512 pages; $29.95. Weidenfeld & Nicolson; £25

Buy it at
Amazon.com
Amazon.co.uk

Seen against the backdrop of what followed, the period 1900-14 was a golden evening of civilisation: a time of social stability, peaceful international relations, political reform and economic integration, leavened by startling technological and cultural progress. Yet as Mr Blom argues in his masterly and panoramic history of Europe in the pre-war years, to the "nervous generation" actually living through it, the era felt rather different. For them it was a time of jarring uncertainties, when solid 19th-century conceptions were corroded and eroded. Rudyard Kipling had mourned the already visible (to him at least) fading of British imperial power in his hugely popular "Recessional". Matthew Arnold, whom Mr Blom quotes in the same passage, wrote of "the long, withdrawing roar" of declining religious faith in his poem "Dover Beach".

Scientific notions such as radioactivity, and the spooky new business of X-rays, were turning things upside down too. So were philosophers such as Bertrand Russell and Ludwig von Wittgenstein. "If scientific analysis made the world fall apart, philosophical reason poured acid over the remaining truths," argues Mr Blom. But out of those uncertainties came the age in which we live now.

Mr Blom musters a rich array of details and sources to bolster his argument. His book gives a chapter to each year, stitching together developments in the German-speaking world (his forte) as well as neurotic France, reactionary Russia and self-confident Britain. His themes range from sex to science, from high politics to gruesome crime, from advanced art to popular literature, all dotted with entertaining nuggets of court and other gossip. As the reader reaches the economic and social decline of the English aristocracy after the death of Queen Victoria, it helps to be told that the libidinous King Edward VII was known as "Edward the Caresser" by his disrespectful subjects. Fans of Marcel Proust will be intrigued to know that the French literary titan was obsessed with motorcars: what would now be termed a "petrolhead". And who will see Walt Disney's "Bambi" with the same eyes in the knowledge, waspishly passed on by Mr Blom, that his creator, Felix Salten, was the anonymous author of a notorious pornographic novel?

It is a slight weakness of the book that smaller countries are almost ignored. As the narrative sweeps between the great powers of Europe, the reader is left wondering what happened in, say, the Netherlands (then still an empire), in Sweden or in Italy. A second criticism is a possible over-emphasis on sex. The era was indeed marked by an unbuttoning of Victorian sexual mores, by the activities of some brave if marginal feminists (such as the British campaigners for women's suffrage), by increasing female employment and by a decline in the importance of male muscular strength. It is interesting to see problems ranging from naval shipbuilding to public health viewed through the prism of sexual angst. But it is quite a leap to maintain, as the Vienna-based Mr Blom does, that "all instinct is ultimately sexual."

A third and more substantial point is that much of the then newfangled thinking that Mr Blom describes would have been regarded by most people at the time as deranged, freakish or irrelevant. Sigmund

Freud, Friedrich Nietzsche, Virginia Woolf and Rudolf Steiner all had their followings; their popularity casts revealing light on the cultural and intellectual needs of the time. Their ideas are interesting even today. Yet in his excitement to portray the shock of the new, Mr Blom risks neglecting the fact that the previous century had left a solid legacy. For most people, it was that world—orderly, patriarchal and even devout—that still dominated daily life.

That should not deter the reader from enjoying Mr Blom's impressive and thought-provoking book. His particular gift is to encapsulate complex historical and biographical events pithily and in an illuminating context. The story of Belgium's monarchical colonists in the Congo is a gruesome tale of inhumanity (the bit about children's hands being amputated to punish their parents for slow work is not easily forgotten). It is aptly compared with German and British behaviour in southern Africa. But it also gives the chance to explain how Edward Morel and Roger Casement launched what was, in effect, the first international human-rights campaign, using the mass media to bring an unstoppable torrent of public criticism to bear on the Belgian authorities.

The book brings the fears, enthusiasms and blindspots of the period brilliantly to life. If civilisation lasts another 100 years, perhaps an equally talented historian will one day compare the first decade of this century to its dizzying counterpart before 1914. If so, Mr Blom's book is unlikely to be bettered as a source.

The Vertigo Years: Europe 1900-1914.
By Philipp Blom.
Basic Books; 512 pages; $29.95. Weidenfeld & Nicolson; £25

Colonel Bill Eddy

An earlier envoy

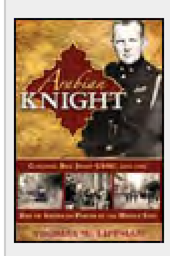
Nov 6th 2008
From The Economist print edition

IF ANYONE could have been America's Lawrence of Arabia it was Colonel William Eddy. He was born to Protestant missionaries in 1896 in Sidon, now part of Lebanon. Fluent in Arabic from a young age, Eddy was tailor-made to be the intermediary between an America which knew little of the Arabs and a desert kingdom whose oil and location made it a tempting prize.

Bill Eddy was from first to last a loyal Marine. Wounded in France in the first world war, he became an intelligence officer in Tangier in 1942-43 and helped prepare the ground for the Allied landing in north Africa. Soon he was named President Franklin Roosevelt's emissary to King Abdel Aziz of Saudi Arabia, Prince Bandar's grandfather (see article). In 1945 he shepherded the battle-scarred old king and his entourage to an historic meeting with FDR on a ship in the Suez canal.

Their arrival on the *USS Murphy*, writes Thomas Lippman, was "at once majestic and bizarre...On a deck covered with colourful carpets and shaded by an enormous tent of brown canvas, a large black-bearded man in Arab robes, his head-dress bound with golden cords, was seated on a gilded throne. Around him stood an entourage of fierce-looking, dark-skinned barefoot men in similar attire, each with a sword or dagger bound to his waist by a gold-encrusted belt. On the *Murphy*'s fantail, sheep grazed in a makeshift corral."

Arabian Knight: Colonel Bill Eddy, USMC, and the Rise of American Power in the Middle East
By Thomas W. Lippman



Selwa Press; 317 pages; $25.95 and £17.50

Buy it at
Amazon.com
Amazon.co.uk

With Colonel Eddy translating, the two leaders got on well. The Saudi king was pleased that Roosevelt promised to take no action on Palestine—where Britain was trying to hold the ring between Arabs and Jews—without first consulting the Arabs. Within weeks of the encounter, though, Roosevelt was dead. When his successor, Harry Truman, committed himself to the Zionist cause, the Saudi monarch felt betrayed.

Eddy, who shared the king's anti-Zionist sentiments, resigned. Back in Washington, he became involved in the great post-war restructuring of American intelligence. When he returned in 1951 to Lebanon, the land of his birth, Eddy worked officially for Aramco, an oil company, and unofficially for the CIA.

Mr Lippman has a nose for the political nuances of the region and a good eye for detail. Noting that Saudis play chess without the bishop or the queen—for which they substitute an elephant and a vizier—he comments wryly: "No Christians or women were going to be checkmating any king in Abdel Aziz's Saudi Arabia."

Arabian Knight: Colonel Bill Eddy, USMC, and the Rise of American Power in the Middle East.
By Thomas W. Lippman.
Selwa Press; 317 pages; $25.95 and £17.50

Patty Hearst

Guns 'n' berets

Nov 6th 2008
From The Economist print edition

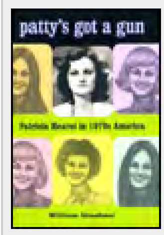
FOR the baby-boom generation the image remains engraved on the memory: a young woman, wearing a black wig and cradling a submachine gun, captured on camera on April 15th 1974 as she helped the Symbionese Liberation Army (SLA) rob a San Francisco bank.

Reuters



Stand and deliver

Patty's Got a Gun: Patricia Hearst in 1970s America
By William Graebner



University of Chicago Press; 218 pages; $20 and £10.50

Buy it at
Amazon.com
Amazon.co.uk

The big question then was why. Patricia Campbell Hearst, a 20-year-old heiress to the Hearst newspaper empire, had been kidnapped by the SLA's urban guerrillas (to give them a polite description) two months earlier. She had been constantly raped and threatened with death. So why was she apparently a willing participant in the bank robbery? Why did she issue a taped message, under the *nom de guerre* Tania, announcing she had joined the SLA? Why did she give covering fire during an abortive robbery of a Los Angeles shop that sold sportswear? Above all, during more than a year of life as a fugitive, why did she not take the many opportunities to escape—or even call her distraught family?

As William Graebner points out, there were no commonly agreed answers at the time; nor are there now. Was Ms Hearst a terrified victim, playing a role lest she be executed? Was she the brainwashed product of “coercive persuasion”, like some American prisoners in the wars of Korea and Vietnam? Or was she “a rebel in search of a cause”, as the prosecution maintained at her trial, and so a volunteer soldier of the SLA? A California jury, unconvinced by psychiatric testimony and by the weak closing argument of Ms Hearst's celebrity defence lawyer, F. Lee Bailey, found her guilty of armed robbery and the use of a firearm to commit a felony. The consequence was a seven-year prison sentence, later commuted by President Jimmy Carter (she served only 22 months, and was given a pardon—oddly not mentioned by Mr Graebner—by President Bill Clinton on his last day in office).

What makes this book worth reading is not so much the first half, a compelling enough account of Ms Hearst's kidnapping and subsequent time in the headlines, as the second half: an attempt to put the Hearst affair in the context of an America struggling to emerge from the Vietnam quagmire and the ignominy of Watergate. The America of the 1970s, he argues, was ridding itself of the legacy of the “permissive” 1960s, and was preparing for the rightward shift of Reaganism and an emphasis in the 1980s on the individual.

Maybe so, and Mr Graebner supports his argument with a host of cultural references, from books by learned academics to music and popular films like “Rambo”, which the author cites as being a quintessential evocation of the heroic individual.

Some of this effort, however, stretches credulity: the break-up of the Beatles and the fact that Paul McCartney played all the instruments on “The Lovely Linda” are apparently proof of “the transition from group to individual”. It is also puzzling in this well-researched book that Mr Graebner fails to broaden his context beyond America: the SLA and contemporaries such as the Black Panthers and the Weathermen were of the same mould and time as Germany's Baader-Meinhof group or Italy's Red Brigades or the Japanese Red Army.

As Mr Graebner puts it, it is possible that in a different decade Ms Hearst might well have been acquitted. Instead, “Patty went to jail because the government's story was the one Americans wanted to hear at

that moment in the mid-1970s; they had had their fill of victims, wanted more than mere survival, and yearned to shed the yoke of determinism.”

Patty’s Got a Gun: Patricia Hearst in 1970s America.
By William Graebner.
University of Chicago Press; 218 pages; $20 and £10.50

Toni Morrison

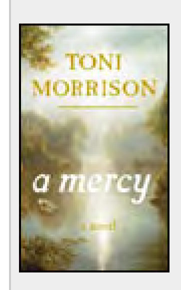
Mercy mission

Nov 6th 2008
From The Economist print edition

TONI MORRISON, winner of the 1993 Nobel prize in literature, returns to the issue of slavery in her new novel, her first in five years. Set in the late 1600s, before bonded labour became the cornerstone of American prosperity, "A Mercy" is a very different book to "Beloved", the novel which won Ms Morrison the Pulitzer prize in 1988 and made her name.

"A Mercy" focuses on the stories of four women, each of them in servitude in a different way: Lina, a Native American servant who is traumatised by the decimation of her tribe; Sorrow, a disturbed survivor of a shipwreck; Florens, "a human child, not pieces of eight", given away by her mother in the hope of a better life (the "mercy" of the title); and Rebekka, their European mistress who, seeking a new life in the New World, marries a man she has never met only to find herself gradually extinguished as one by one her children die.

A Mercy
By Toni Morrison



Knopf; 176 pages; $23.95. Chatto & Windus; £15.99

The book is structured in the author's trademark distilled style, chapters given in turn to each voice, stories building on stories, time weaving back and forth. Throughout the author explores important themes: how far the fingers of slavery reached in colonial America, touching people regardless of race, class or sex; how reliant those seeking their way in the New World were upon others for survival; the importance of a community in which to live and thrive.

Underpinning it all is the premise that the ultimate right of humans is to be free. As Florens's mother says at the end of the book, "to be given dominion over another is a hard thing; to wrest dominion over another is a wrong thing; to give dominion of yourself to another is a wicked thing."

A Mercy.
By Toni Morrison.
Knopf; 176 pages; $23.95. Chatto & Windus; £15.99

Martín Ramírez

Spit and crayons

Nov 6th 2008
From The Economist print edition

The Estate of Martin Ramirez



The animating spirit of life in a psychiatric institution

MARTIN RAMIREZ spent most of his adult life in mental hospitals. He taught himself to paint, using whatever he could lay his hands on: food, pencils, crayons, shoe polish, even his own saliva coloured by chewing up newspaper illustrations. To make the huge pieces of paper he liked to work on, he used newspaper, grocery bags and thin medical-examination sheets, glued together with a paste of spit and mashed potatoes. For decades he has been considered an oddball artist, America's answer to Richard Dadd.

Then in January 2007 the American Folk Art Museum in New York mounted a retrospective of Ramírez's work. Brooke Davis Anderson, the curator, publicised the show in local papers around Auburn, California, where Ramírez had been hospitalised, in the hope that people would come forward with new undocumented works. After a few false leads, she received a brief e-mail from the descendants of Max Dunievitz, who had been a medical officer at DeWitt State Hospital in Auburn in the early 1960s. When Ms Anderson flew out to California, she discovered the family had more than 120 pictures in good condition, stored in boxes in a garage. These were the artist's last works, created between 1960 and 1963, the year he died.

Thanks to that earlier show, Ramírez's work has enjoyed a complete reappraisal. Far from being a kooky outsider who merely exorcised images from his subconscious, he is now understood as an artist inspired by the imagery of his hard life. His hundreds of drawings and collages vibrate with a rare intensity of hypnotic lines and warmly muted colours. Subjects and symbols are constantly reiterated in his distinctive, obsessive style. “There is something remarkable going on here,” says Nancy Druckman, head of Sotheby's American folk art department.

Now a new show at the American Folk Art Museum features 25 previously unseen pictures from the Dunievitz collection. A cartoonish man on a horse gazes at the viewer, melancholic, vulnerable and isolated on a stage; a train rounds a bend of reverberating curves and enters a mysteriously dark tunnel; arches are arranged in a portentous grid; a Madonna looms tall, beatific and symmetrical, like a chess queen. Seen together, they evoke a narrative of lonesome migration and nostalgia for what was left behind.

Born in 1895 in Jalisco, Mexico, Ramírez travelled to California in the 1920s in search of work to support his family. With no formal education, he busied himself as a sharecropper and day-labourer, working on railways and in mines until the Depression hit. In 1931 he was arrested, haggard, confused and unable to communicate in English. He was diagnosed with catatonic schizophrenia and spent the next 32 years in mental asylums. It was during this period, particularly the 15 later years he spent at DeWitt, that he created hundreds of drawings and collages. It was his life's work. He hardly spoke to anyone.

Tarmo Pasto, a psychology professor, was the first person to preserve Ramírez's drawings. Hoping to study the link between madness and artistic creativity, he provided Ramírez with materials and support, and helped to find an audience for his work. Pasto sent the drawings to mainstream museums, such as New York's Museum of Modern Art and the Guggenheim, but was met with resistance. “This material is very perplexing to everyone,” explained a representative at the Guggenheim. “It doesn't fit comfortably within the canon. It doesn't fit comfortably anywhere.”

Dunievitz also supplied art materials to Ramírez and encouraged him. He dated the drawings, making it easier to study Ramírez's stylistic developments and to analyse the changes. These newly discovered works are better preserved than those from the Pasto collection—more colourful, more vibrant and on crisper paper. But with their lone riders and beacon-like Madonnas, they continue to tell the same story of a man who has travelled so far from home, never to return.

Studs Terkel

Nov 6th 2008
From The Economist print edition

AP



Louis "Studs" Terkel, recorder of America's voices, died on October 31st, aged 96

THEY fetched up together almost five years ago, the lanky young politician striving for the Senate and the short, puckish, pot-bellied 91-year-old, one in a suit and the other in a red-and-white check shirt with a dry Martini in his fist. The setting was Studs Terkel's version of paradise, the basement of a pub in ice-cold Chicago, full of student Democrats and weary working folk, where the air was thick with smoke and the floor was sticky with beer; and Mr Terkel introduced Barack Obama to the crowd as an intellectual, wondering aloud whether Americans deserved that sort of person in high office.

In a life spent talking and, above all, listening to the voices of his fellow Americans, he rarely made time for intellectuals. Their eloquence, he said, came too easy. He preferred the "inchoate thought" of people who were never heard. Billy Joe Gatewood, for example, fresh out of eastern Kentucky, a 19-year-old shipping clerk: "The biggest thing on my mind is I work nine hours a day and I come home and the tensions build up and I don't know how to get it out sometimes." The black farmer near Tchula, Mississippi: "The Negroes in the South done got to the height of their growthin'. They ain't getting' further." The marine, thinking of Hiroshima, who remembered: "We were sitting on the pier, sharpening our bayonets, when Harry dropped that beautiful bomb. The greatest thing that ever happened." Or Dolores Dante, a waitress, talking about her work:

> Some don't care. When the plate is down you can hear the sound. I try not to have that sound. I want my hands to be right when I serve. I pick up a glass, I want it to be just right… To be a waitress, it's an art.

Mr Terkel was asked about immortality once. He said he believed in it, but not in the form of the 9,000 chat shows he had recorded for WFMT in Chicago over 45 years of working for them. It lay in the fact that a man had stopped him on the Michigan Avenue bridge and told him that, after reading the words of Dolores, he was never going to be rude to a waitress again. Whether Studs was immortal or not, Dolores was.

It happened all the time: writers attempted to anatomise Mr Terkel and, instead, got a deluge of other lives, recorded either in books ("Division Street", "Race", "American Dreams", "Hard Times") or in that

gentle, raspy, baddie's voice of the radio shows. He wrote memoirs but, like a jazzman improvising on a theme, wandered off inveterately after other people: "An accidental shove on a crowded Loop corner, while awaiting the change in traffic lights; an apology; a phrase that holds my attention; we go for coffee; a life unfolded at the restaurant table."

His childhood too was recounted in terms of voices, crackling faintly out of the crystal set or booming from the radio as he sat inside listening, even in summer. Mastoiditis made his bandaged ears ache, but still he tuned in to the hubbub of the streets. His youth revolved round stories heard at his parents' lodging house at Wells and Grand in Chicago; tales from dishwashers ("pearl-divers"), strike-breakers ("scissorbills"), clerks and sanitation workers, the toothless radical Ed Sprague with his diet of bread and milk and Big Ole, his lobby nemesis, who banged the drum for J.P. Morgan. "Theirs was the American yawp," he wrote. "Every man a king. Every man a Demosthenes." Not far away, in Bughouse Square, men who were barely articulate stood on soapboxes to describe their lives and dreams to anyone who would listen. He always would.

Catching the light

Mr Terkel was a man on a mission. First, he meant to fix memories before they faded, especially memories of the fight for the eight-hour day, for union representation and civil rights. Second, he meant to establish the dignity of Everyman. He was alert to all the degrees of humiliation, from his own in 1934, passed on by a professor to the FBI ("Slovenly, a low-class Jew. He is not one of our type of boys"), to the loss of face suffered by a man who lost a nickel in a pinochle game. But he redressed the balance by treating everyone he interviewed as precious and unique, and their words as poetry. Hobart Foote, who had to cross multiple railway lines to get to work: "Catch this light at a certain time, and then you've got the next light. But if there's a train there, I take off down Cicero Avenue." The retired baseball player: "The hardest ball I ever hit, and I felt the zest of it, the ball was caught." Or the Boston cab-driver:

> Since I was a kid I tried to become an eagle. …Finally, thank God, after so long a time and so many tries and so much money spent, my sun came up and the snow started melting. My wings start drying, maybe to fly again.

"Astonishing" was how Mr Terkel often described his work. The words were elicited in the course of rambling conversations, with a kick or a cuss at the clumsy recorder he found so hard to operate, and then played back to people who could sometimes scarcely believe their own voice or their own thoughts. Talking to Mr Terkel, the copyboy or the short-order clerk or the welfare mother felt, at last, like somebody. They counted; they had possibilities. And no one more than that lanky young politician, not even yet his party's nominee, who talked to him on that cold Chicago evening in 2004, a new voice.



Overview

Nov 6th 2008
From The Economist print edition

A clutch of business surveys suggests that the **world economy** is turning down sharply. In America the Institute for Supply Management's manufacturing index plunged in October to 38.9, the lowest reading since 1982. A reading below 50 indicates falling activity. The index for non-manufacturing fell from 50.2 to 44.4. In the euro area the purchasing managers' index (PMI), based on surveys of buyers in manufacturing and service industries, dropped from 46.9 to 43.6, the lowest reading since the survey began in 1998. Britain's manufacturing PMI edged up to 41.5 and the index for services fell from 46.0 to 42.4.

Australia's central bank cut its benchmark interest rate from 6% to 5.25% on November 4th. The Reserve Bank of **India** reduced its key interest rate by half a percentage point, to 7.5%, less than a fortnight after it had taken the rate down from 9% to 8%. **Vietnam's** central bank reduced its main interest rate from 13% to 12%.

Consumer-price inflation in the **euro area** fell from 3.6% to 3.2% in October, according to a preliminary estimate. Retail sales fell by 0.2% in September, leaving them 1.6 lower than a year earlier.

Britain's manufacturing output fell for a seventh consecutive month in September.

Analysts have slashed their forecasts for GDP growth and inflation, according to *The Economist's* **monthly poll of forecasters**. The economies of America, the euro area and Britain are now expected to shrink next year.



Output, prices and jobs

Nov 6th 2008
From The Economist print edition

Output, prices and jobs

% change on year ago

	Gross domestic product				Industrial production	Consumer prices			Unemployment
	latest	qtr*	2008†	2009†	latest	latest	year ago	2008†	rate‡, %
United States	+0.8 Q3	−0.3	+1.4	−0.2	−4.5 Sep	+4.9 Sep	+2.8	+4.3	6.1 Sep
Japan	+0.7 Q2	−3.0	+0.5	−0.1	+0.4 Sep	+2.1 Sep	−0.2	+1.7	4.0 Sep
China	+9.0 Q3	na	+9.8	+8.5	+11.4 Sep	+4.6 Sep	+6.2	+6.4	9.5 2007
Britain	+0.3 Q3	−2.0	+0.9	−1.0	−2.2 Sep	+5.2 Sep§	+1.8	+3.8	5.7 Aug††
Canada	+0.7 Q2	+0.3	+0.6	+0.5	−3.3 Aug	+3.4 Sep	+2.5	+2.8	6.1 Sep
Euro area	+1.4 Q2	−0.7	+1.1	−0.1	−0.7 Aug	+3.2 Oct	+2.6	+3.3	7.5 Sep
Austria	+2.2 Q2	+1.5	+2.0	+0.8	+4.6 Aug	+3.7 Sep	+2.1	+2.9	3.2 Sep
Belgium	+1.2 Q3	+0.4	+1.4	+0.3	−5.0 Aug	+4.7 Oct	+2.2	+4.6	10.9 Sep‡‡
France	+1.1 Q2	−1.3	+0.9	nil	−2.6 Aug	+3.0 Sep	+1.5	+3.2	7.9 Sep
Germany	+1.7 Q2	−2.0	+1.4	−0.2	+1.7 Aug	+2.4 Oct	+2.8	+2.8	7.5 Oct
Greece	+3.5 Q2	+3.1	+2.4	+1.5	−1.8 Aug	+4.6 Sep	+2.9	+4.6	7.0 Jul
Italy	−0.1 Q2	−1.1	−0.1	−0.4	−5.3 Aug	+3.5 Oct	+2.1	+3.5	6.8 Q2
Netherlands	+3.0 Q2	+0.5	+2.1	+0.5	−1.3 Aug	+2.8 Oct	+1.6	+2.5	3.8 Sep††
Spain	+1.8 Q2	+0.4	+1.3	−0.5	−4.5 Sep	+4.5 Sep	+2.7	+4.5	11.9 Sep
Czech Republic	+4.6 Q2	+3.6	+4.5	+4.3	−2.6 Aug	+6.6 Sep	+2.8	+6.6	5.3 Sep
Denmark	+0.9 Q2	+1.6	+0.2	nil	−0.2 Aug	+4.2 Sep	+1.2	+3.5	1.6 Sep
Hungary	+2.0 Q2	+2.3	+2.0	+3.0	−0.7 Sep	+5.7 Sep	+6.4	+6.7	7.7 Sep††
Norway	+5.9 Q2	+2.4	+2.5	+2.2	−5.7 Aug	+5.3 Sep	−0.3	+3.3	2.4 Jul***
Poland	+5.8 Q2	na	+5.4	+4.3	+7.0 Sep	+4.5 Sep	+2.3	+4.2	8.9 Sep‡‡
Russia	+7.8 Q2	na	+7.5	+6.8	+6.3 Sep	+16.1 Sep	+9.4	+14.0	5.3 Sep‡‡
Sweden	+0.7 Q2	−0.1	+1.1	+0.5	−4.9 Sep	+4.4 Sep	+2.2	+3.7	5.9 Sep‡‡
Switzerland	+2.4 Q2	+1.5	+1.9	+0.4	+6.1 Q2	+2.6 Oct	+1.3	+2.6	2.6 Sep
Turkey	+1.9 Q2	na	+3.7	+3.2	−4.0 Aug	+12.0 Oct	+7.0	+10.2	9.0 Q3‡‡
Australia	+2.7 Q2	+1.1	+2.6	+1.9	+2.8 Q2	+5.0 Q3	+1.9	+4.4	4.3 Oct
Hong Kong	+4.2 Q2	−5.5	+3.8	+2.1	−4.2 Q2	+3.0 Sep	+1.6	+5.3	3.4 Sep††
India	+7.9 Q2	na	+7.3	+6.8	+1.3 Aug	+9.8 Sep	+6.4	+7.9	7.2 2007
Indonesia	+6.5 Q2	na	+5.8	+5.5	+2.9 Aug	+11.8 Oct	+5.8	+10.3	8.5 Feb
Malaysia	+6.3 Q2	na	+5.6	+4.6	+0.9 Aug	+8.2 Sep	+1.8	+5.8	3.5 Q2
Pakistan	+5.8 2008**	na	+6.0	+4.2	−5.6 Aug	+23.9 Sep	+8.4	+21.0	5.6 2007
Singapore	−0.5 Q3	−6.3	+4.0	+3.8	+2.4 Sep	+6.7 Sep	+2.7	+6.5	2.2 Q3
South Korea	+3.9 Q3	+2.3	+4.6	+3.3	+6.1 Sep	+4.8 Oct	+3.0	+4.9	3.1 Sep
Taiwan	+4.3 Q2	na	+4.0	+3.4	−1.4 Sep	+2.4 Oct	+5.3	+3.8	4.1 Sep
Thailand	+5.3 Q2	+2.9	+4.8	+3.9	+7.9 Aug	+3.9 Oct	+2.5	+6.4	1.3 Jul
Argentina	+7.5 Q2	+8.7	+6.2	+2.5	+4.4 Sep	+8.7 Sep	+8.6	+9.0	7.8 Q3‡‡
Brazil	+6.1 Q2	+6.6	+5.3	+2.7	+9.8 Sep	+6.3 Sep	+4.1	+5.8	7.6 Sep‡‡
Chile	+4.3 Q2	+7.4	+3.9	+3.3	+3.2 Sep	+9.9 Oct	+6.5	+8.7	7.8 Sep††‡‡
Colombia	+3.7 Q2	+2.8	+4.5	+4.0	−8.8 Aug	+7.6 Sep	+5.0	+6.7	11.1 Aug‡‡
Mexico	+2.8 Q2	+0.6	+1.9	+0.9	−1.6 Aug	+5.5 Sep	+3.8	+5.3	4.3 Sep‡‡
Venezuela	+7.1 Q2	na	+5.4	+2.7	+3.6 Jul	+36.0 Sep	+15.3	+31.0	7.5 Q2††
Egypt	+6.8 Q2	na	+7.1	+6.7	+6.8 Q2	+21.5 Sep	+9.3	+17.1	8.4 Q2‡‡
Israel	+4.9 Q2	+4.2	+4.2	+2.8	+13.9 Aug	+5.5 Sep	+1.4	+4.8	5.9 Q2
Saudi Arabia	+3.5 2007	na	+6.5	+3.3	na	+10.4 Sep	+4.9	+8.5	na
South Africa	+4.5 Q2	+4.9	+3.4	+3.3	+0.4 Aug	+13.1 Sep	+7.2	+11.3	23.2 Sep‡‡
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*									
Estonia	−1.1 Q2	−3.2	−1.5	+0.4	−3.8 Sep	+10.5 Sep	+7.2	+10.5	4.0 Jul
Finland	+2.4 Q2	+3.1	+2.6	+1.1	+0.8 Sep	+4.7 Sep	+2.6	+4.0	6.5 Sep
Iceland	+5.0 Q2	+20.9	nil	+0.8	+0.4 2007	+15.9 Oct	+4.5	+12.0	1.3 Sep‡‡
Ireland	−0.8 Q2	−2.1	−0.5	−0.1	+4.2 Aug	+4.3 Sep	+4.6	+4.0	6.7 Oct
Latvia	+0.1 Q2	na	−0.4	−0.5	−5.4 Sep	+14.9 Sep	+11.4	+15.8	5.7 Jul
Lithuania	+3.1 Q3	+1.6	+5.1	+3.7	na	+11.1 Sep	+7.0	+10.8	4.7 Aug‡‡
Luxembourg	+2.8 Q2	+4.5	+2.8	+2.6	+11.9 Aug	+4.0 Sep	+2.1	+4.0	4.3 Sep‡‡
New Zealand	−0.3 Q2	−2.1	+0.4	+1.5	+2.4 Q2	+5.1 Q3	+1.8	+4.1	4.2 Q3
Peru	+8.9 Aug	na	+9.1	+6.5	+5.6 Aug	+6.5 Oct	+3.1	+5.7	7.7 Sep††
Philippines	+4.6 Q2	+8.4	+4.5	+3.9	+8.1 Jul	+11.2 Oct	+2.7	+9.7	7.4 Q3‡‡
Portugal	+0.7 Q2	+1.4	+0.7	nil	−0.4 Aug	+3.1 Sep	+2.1	+2.8	7.3 Q2‡‡
Slovakia	+7.6 Q2	na	+7.0	+5.2	+0.9 Aug	+5.4 Sep	+2.9	+4.4	7.5 Sep‡‡
Slovenia	+5.5 Q2	na	+4.2	+2.8	−7.1 Aug	+4.9 Oct	+5.1	+6.0	6.4 Aug‡‡

*% change on previous quarter, annual rate. †*The Economist* poll or Economist Intelligence Unit estimate/forecast. ‡National definitions.- §RPI inflation rate 5.0% in Sept. ††Latest three months. ‡‡Not seasonally adjusted. ***Centred 3-month average

Sources: National statistics offices and central banks; Thomson Datastream; Reuters; Centre for Monitoring Indian Economy; OECD; ECB

The Economist commodity-price index

Nov 6th 2008
From The Economist print edition

The Economist commodity-price index

2000=100

	Oct 28th	Nov 4th*	% change on one month	% change on one year
Dollar index				
All items	164.6	172.2	-9.6	-20.7
Food	174.6	185.3	-4.6	-5.8
Industrials				
All	151.8	155.3	-16.2	-36.2
Nfa†	129.3	136.6	-11.2	-22.3
Metals	164.1	165.5	-18.3	-41.0
Sterling index				
All items	160.1	162.5	-1.0	+3.0
Euro index				
All items	122.0	122.8	-4.9	-11.0
Gold				
$ per oz	738.15	761.00	-13.3	-7.6
West Texas Intermediate				
$ per barrel	63.20	70.08	-22.0	-27.3

*Provisional †Non-food agriculturals.

The Economist poll of forecasters, November averages

Nov 6th 2008
From The Economist print edition

The Economist poll of forecasters, November averages (previous month's, if changed)

	Real GDP, % change				Consumer prices % increase		Current account % of GDP	
	Low/high range		average					
	2008	2009	2008	2009	2008	2009	2008	2009
Australia	2.0/3.4	0.7/2.8	2.6	1.9 (2.3)	4.4 (4.2)	3.2	-5.4 (-5.1)	-5.2 (-4.5)
Belgium	1.1/1.6	-0.4/1.2	1.4 (1.5)	0.3 (0.9)	4.6 (4.5)	2.3 (2.6)	1.6	1.6
Britain	0.8/1.0	-1.8/-0.3	0.9 (1.1)	-1.0 (0.1)	3.8	2.4 (2.9)	-3.0 (-3.1)	-2.8 (-2.5)
Canada	0.4/1.1	-0.2/1.2	0.6 (0.8)	0.5 (1.4)	2.8	2.2 (2.5)	0.9 (1.1)	-0.5 (0.3)
France	0.7/1.2	-1.2/1.4	0.9 (1.1)	nil (0.7)	3.2	1.7 (2.1)	-1.7 (-1.8)	-1.9
Germany	1.2/1.6	-1.5/0.8	1.4 (1.6)	-0.2 (0.6)	2.8 (2.9)	1.7 (2.1)	6.7 (6.5)	5.9
Italy	-0.2/0.2	-1.3/0.7	-0.1 (0.1)	-0.4 (0.3)	3.5 (3.6)	2.2 (2.5)	-2.9 (-2.5)	-2.7 (-2.3)
Japan	0.1/0.8	-1.9/0.7	0.5 (0.7)	-0.1 (0.6)	1.7 (1.8)	0.7 (1.2)	4.0 (3.9)	4.1
Netherlands	2.0/2.3	-0.4/1.2	2.1	0.5 (1.0)	2.5	2.1 (2.3)	6.7 (6.2)	5.8 (5.9)
Spain	0.9/1.8	-2.0/1.2	1.3 (1.4)	-0.5 (0.3)	4.5	2.7 (2.9)	-10.0 (-9.8)	-8.8 (-8.9)
Sweden	0.7/2.2	-0.8/2.2	1.1 (1.3)	0.5 (1.0)	3.7 (3.8)	2.2 (2.6)	7.7 (7.6)	7.5 (7.3)
Switzerland	1.6/2.2	-1.2/1.3	1.9 (2.0)	0.4 (1.1)	2.6	1.4 (1.7)	12.0 (13.0)	11.9 (12.6)
United States	1.1/2.0	-1.0/1.8	1.4 (1.6)	-0.2 (0.6)	4.3 (4.5)	1.8 (2.6)	-4.6 (-4.7)	-3.3 (-4.1)
Euro area	0.9/1.3	-1.4/1.0	1.1 (1.2)	-0.1 (0.6)	3.3 (3.5)	2.0 (2.3)	-0.4	-0.2 (-0.3)

Sources: ABN AMRO, BNP Paribas, Citigroup, Decision Economics, Deutsche Bank, Economist Intelligence Unit, Goldman Sachs, HSBC Securities, KBC Bank, JPMorgan Chase, Morgan Stanley, Scotiabank, UBS



Trade, exchange rates, budget balances and interest rates

Nov 6th 2008
From The Economist print edition

Trade, exchange rates, budget balances and interest rates

	Trade balance* latest 12 months, $bn	Current-account balance latest 12 months, $bn	Current-account balance % of GDP 2008†	Currency units, per $ Nov 5th	Currency units, per $ year ago	Budget balance % of GDP 2008†	Interest rates, % 3-month latest	Interest rates, % 10-year gov't bonds, latest
United States	−848.0 Aug	−699.0 Q2	−4.6	–	–	−3.2	1.95	3.69
Japan	+77.9 Aug	+197.3 Aug	+4.0	99.4	113	−3.0	0.64	1.52
China	+258.0 Sep	+371.8 2007	+8.5	6.83	7.44	0.4	3.99	3.17
Britain	−188.9 Aug	−82.9 Q2	−3.0	0.62	0.48	−3.8	5.58	4.42
Canada	+50.8 Aug	+13.6 Q2	+0.9	1.16	0.92	0.2	1.75	3.97
Euro area	−26.4 Aug	−36.2 Aug	−0.4	0.77	0.68	−0.9	4.66	3.77
Austria	−0.3 Aug	+14.5 Q2	+2.9	0.77	0.68	−1.0	4.66	4.45
Belgium	+3.3 Jul	−9.8 Jun	+1.6	0.77	0.68	−0.6	4.73	4.50
France	−76.9 Aug	−54.2 Aug	−1.7	0.77	0.68	−2.9	4.66	4.26
Germany	+279.8 Aug	+269.3 Aug	+6.7	0.77	0.68	1.1	4.66	3.76
Greece	−67.2 Jul	−50.8 Aug	−14.0	0.77	0.68	−3.3	4.66	5.25
Italy	−15.4 Aug	−71.1 Aug	−2.9	0.77	0.68	−2.6	4.66	4.76
Netherlands	+60.1 Aug	+62.5 Q2	+6.7	0.77	0.68	0.7	4.66	4.27
Spain	−154.9 Aug	−165.3 Aug	−10.0	0.77	0.68	−1.6	4.66	4.43
Czech Republic	+6.3 Sep	−4.3 Aug	−2.8	18.7	18.3	−1.9	4.46	4.62
Denmark	+6.4 Aug	+5.9 Aug	+1.2	5.70	5.08	3.8	7.30	4.30
Hungary	+0.5 Aug	−8.8 Q2	−5.5	197	173	−3.8	11.64	11.36
Norway	+83.2 Sep	+78.1 Q2	+17.3	6.66	5.30	17.7	6.45	4.38
Poland	−22.2 Aug	−26.3 Aug	−4.9	2.70	2.48	−1.9	6.84	6.35
Russia	+200.3 Aug	+116.5 Q3	+6.2	26.7	24.5	4.5	11.00	8.60
Sweden	+19.0 Sep	+38.6 Q2	+7.7	7.68	6.30	2.4	3.25	3.61
Switzerland	+17.3 Sep	+60.2 Q2	+12.0	1.16	1.13	0.9	2.60	2.74
Turkey	−75.6 Sep	−48.7 Aug	−6.4	1.50	1.18	−1.8	21.20	10.40‡
Australia	−14.0 Sep	−61.1 Q2	−5.4	1.43	1.07	1.3	5.13	5.33
Hong Kong	−26.1 Sep	+27.5 Q2	+10.8	7.75	7.77	0.7	2.55	2.09
India	−106.5 Sep	−21.9 Q2	−2.9	47.5	39.3	−4.3	7.42	8.15
Indonesia	+17.3 Sep	+6.3 Q2	+2.8	10,900	9,120	−2.0	12.38	11.27‡
Malaysia	+41.0 Aug	+35.3 Q2	+13.7	3.53	3.33	−4.8	3.64	5.70‡
Pakistan	−22.5 Sep	−14.0 Q2	−7.2	81.0	60.9	−6.7	14.96	24.19‡
Singapore	+22.9 Sep	+32.8 Q2	+18.6	1.48	1.44	1.0	1.00	2.63
South Korea	−12.2 Oct	−10.6 Sep	−3.3	1,266	906	1.1	5.87	5.43
Taiwan	+6.9 Sep	+32.6 Q2	+5.6	32.8	32.4	−1.8	2.55	2.06
Thailand	+3.7 Sep	+5.4 Sep	+1.1	35.0	34.0	−2.9	3.85	3.73
Argentina	+15.9 Sep	+6.0 Q2	+2.8	3.30	3.13	0.7	21.50	na
Brazil	+26.5 Oct	−25.2 Sep	−1.8	2.11	1.73	−1.6	13.65	6.16‡
Chile	+16.1 Sep	+1.0 Q2	−0.5	631	503	6.5	9.00	4.99‡
Colombia	+2.3 Aug	−4.9 Q2	−2.6	2,312	2,026	−1.0	10.07	8.52‡
Mexico	−11.3 Sep	−5.3 Q2	−0.8	12.5	10.7	nil	7.10	8.94
Venezuela	+41.9 Q2	+37.8 Q2	+14.8	4.93	6.20§	1.6	17.02	6.55‡
Egypt	−23.4 Q2	+0.9 Q2	+0.2	5.54	5.50	−7.1	12.76	7.08‡
Israel	−13.7 Sep	+3.5 Q2	+0.9	3.81	3.92	−0.8	3.53	5.37
Saudi Arabia	+150.8 2007	+95.0 2007	+31.7	3.76	3.74	13.3	4.10	na
South Africa	−10.6 Sep	−22.5 Q2	−7.7	9.60	6.47	0.2	12.40	8.68
MORE COUNTRIES Data for the countries below are not provided in printed editions of *The Economist*								
Estonia	−4.3 Aug	−3.3 Aug	−11.8	12.0	10.7	−0.5	6.87	na
Finland	+11.9 Aug	+10.6 Aug	+3.8	0.77	0.68	4.5	4.70	4.34
Iceland	−0.6 Oct	−4.5 Q2	−14.6	126	58.9	2.0	18.44	na
Ireland	+39.0 Aug	−15.8 Q2	−3.5	0.77	0.68	−3.9	4.66	4.74
Latvia	−6.9 Aug	−5.5 Aug	−15.0	0.54	0.48	−1.5	10.19	na
Lithuania	−8.0 Aug	−6.8 Aug	−14.0	2.64	2.35	−0.7	8.40	na
Luxembourg	−6.9 Aug	+5.1 Q2	na	0.77	0.68	0.5	4.66	na
New Zealand	−3.7 Sep	−11.4 Q2	−7.1	1.65	1.27	0.3	6.75	6.00
Peru	+6.3 Aug	−1.5 Q2	−1.6	3.07	3.00	2.7	6.55	na
Philippines	−8.5 Aug	+4.3 Jun	+2.0	48.1	43.3	−0.9	4.31	na
Portugal	−32.9 Jul	−27.9 Jul	−9.7	0.77	0.68	−2.4	4.66	4.71
Slovakia	−0.9 Aug	−6.1 Jul	−5.6	23.3	22.6	−2.1	2.12	4.57
Slovenia	−4.5 Aug	−3.5 Aug	−6.6	0.77	0.68	0.4	4.66	na

*Merchandise trade only. †*The Economist* poll or Economist Intelligence Unit forecast. ‡Dollar-denominated bonds. §Unofficial exchange rate.
Sources: National statistics offices and central banks; Thomson Datastream; Reuters; JPMorgan; Bank Leumi le-Israel; Centre for Monitoring Indian Economy; Danske Bank; Hong Kong Monetary Authority; Standard Bank Group; UBS; Westpac.

Markets

Nov 6th 2008
From The Economist print edition

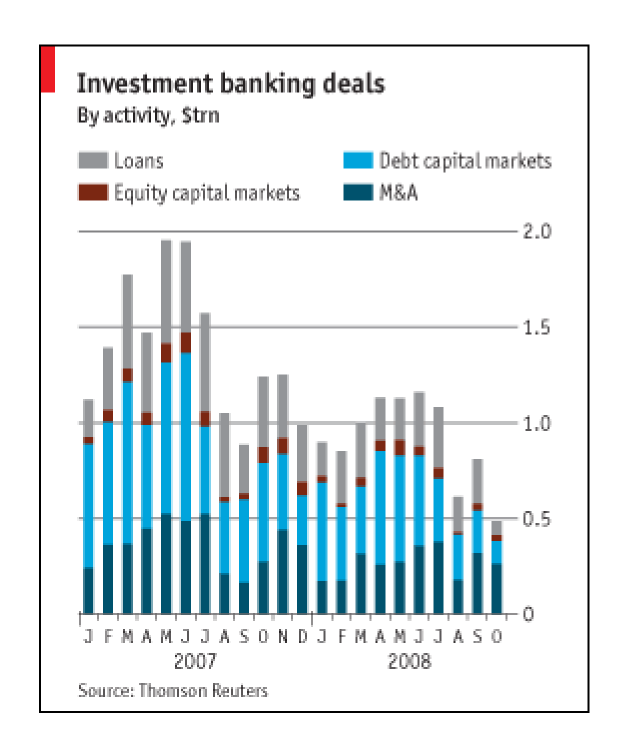
Markets

		% change on		
			Dec 31st 2007	
	Index Nov 5th	one week	in local currency	in $ terms
United States (DJIA)	9,139.3	+1.6	−31.1	−31.1
United States (S&P 500)	952.8	+2.4	−35.1	−35.1
United States (NAScomp)	1,681.6	+1.5	−36.6	−36.6
Japan (Nikkei 225)	9,521.2	+15.9	−37.8	−30.1
Japan (Topix)	966.9	+16.5	−34.5	−26.4
China (SSEA)	1,849.6	+2.4	−66.5	−64.2
China (SSEB, $ terms)	92.4	+6.6	−76.4	−74.7
Britain (FTSE 100)	4,530.7	+6.8	−29.8	−43.0
Canada (S&P TSX)	9,887.2	+4.1	−28.5	−39.1
Euro area (FTSE Euro 100)	826.0	+8.2	−39.9	−46.4
Euro area (DJ STOXX 50)	2,710.7	+7.8	−38.4	−45.0
Austria (ATX)	2,097.1	+15.1	−53.5	−58.5
Belgium (Bel 20)	2,199.4	+8.7	−46.7	−52.4
France (CAC 40)	3,618.1	+6.3	−35.6	−42.4
Germany (DAX)*	5,166.9	+7.4	−36.0	−42.8
Greece (Athex Comp)	2,221.0	+12.8	−57.1	−61.7
Italy (S&P/MIB)	22,758.0	+11.2	−41.0	−47.3
Netherlands (AEX)	279.4	+7.7	−45.8	−51.6
Spain (Madrid SE)	1,043.7	+12.6	−36.4	−43.2
Czech Republic (PX)	904.0	+14.2	−50.2	−51.6
Denmark (OMXCB)	279.6	+13.7	−37.7	−44.3
Hungary (BUX)	14,399.6	+7.5	−45.1	−51.9
Norway (OSEAX)	325.3	+21.8	−42.9	−53.5
Poland (WIG)	29,070.6	+5.7	−47.8	−52.3
Russia (RTS, $ terms)	829.8	+28.9	−60.6	−63.8
Sweden (Aff.Gen)	213.1	+13.8	−37.4	−47.3
Switzerland (SMI)	6,177.2	+5.0	−27.2	−28.9
Turkey (ISE)	27,855.9	+11.9	−49.8	−60.9
Australia (All Ord.)	4,287.3	+12.7	−33.2	−48.4
Hong Kong (Hang Seng)	14,840.2	+16.8	−46.6	−46.3
India (BSE)	10,120.0	+11.9	−50.1	−58.6
Indonesia (JSX)	1,366.3	+22.7	−50.2	−57.1
Malaysia (KLSE)	915.2	+10.3	−36.7	−40.6
Pakistan (KSE)	9,183.1	nil	−34.8	−50.3
Singapore (STI)	1,868.8	+11.8	−46.1	−47.4
South Korea (KOSPI)	1,181.5	+21.9	−37.7	−53.9
Taiwan (TWI)	4,978.3	+13.0	−41.5	−42.2
Thailand (SET)	457.4	+19.1	−46.7	−48.7
Argentina (MERV)	1,135.8	+23.7	−47.2	−49.6
Brazil (BVSP)	37,785.0	+8.4	−40.9	−50.1
Chile (IGPA)	12,210.5	+5.4	−13.3	−31.6
Colombia (IGBC)	7,183.3	+3.2	−32.8	−41.4
Mexico (IPC)	20,446.8	+6.7	−30.8	−39.8
Venezuela (IBC)	35,423.0	−1.4	−6.5	−59.5
Egypt (Case 30)	5,354.4	+9.6	−48.9	−49.0
Israel (TA-100)	696.5	+8.3	−39.7	−39.1
Saudi Arabia (Tadawul)	6,083.9	+9.9	−44.9	−45.0
South Africa (JSE AS)	20,951.0	+5.8	−27.7	−48.5
Europe (FTSEurofirst 300)	953.2	+6.3	−36.7	−43.5
World, dev'd (MSCI)	983.0	+6.3	−38.1	−38.1
Emerging markets (MSCI)	600.2	+18.3	−51.8	−51.8
World, all (MSCI)	243.0	+7.4	−39.7	−39.7
World bonds (Citigroup)	739.9	+0.2	+1.3	+1.3
EMBI+ (JPMorgan)	366.8	+9.6	−15.4	−15.4
Hedge funds (HFRX)	1,072.9	+0.6	−19.3	−19.3
Volatility, US (VIX)	54.6	70.0	22.5	(levels)
CDSs, Eur (iTRAXX)†	131.8	−17.1	+160.5	+132.6
CDSs, N Am (CDX)†	195.4	−14.1	+150.9	+150.9
Carbon trading (EU ETS) €	18.6	+0.5	−16.3	−25.3

*Total return index. †Credit-default swap spreads, basis points.
Sources: National statistics offices, central banks and stock exchanges; Thomson Datastream; Reuters; WM/Reuters; JPMorgan Chase; Bank Leumi le-Israel; CBOE; CMIE; Danske Bank; EEX; HKMA; Markit; Standard Bank Group; UBS; Westpac.

Investment-banking deals

Nov 6th 2008
From The Economist print edition



The total volume of investment-banking deals fell to $486.8 billion in October 2008, from $810.6 billion a month earlier. Loans saw the biggest drop, with volumes falling by over two-thirds between September and October. Debt capital-market deals followed, falling to just over half their September level. Global syndicated loan issuance in October was lower than in any other month this year. In equity capital markets the withdrawn or postponed IPOs exceeded completed issues for the second month in a row. The number of bankruptcy-related M&A deals rose in 2008 for the first time in six years. Almost a third of global M&A activity in October was the partial nationalisation of financial institutions.